Policies for Competitiveness and Development in the Czech Republic during Transition Period

Introduction to the Policies of Transition Based on the Czech Case, 1980–2008

Vladimír Benáček [1]

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PART I:
Czech Policies of Competitiveness Promoting Investment, Restructuring and Development

This study is a part of an international project "Public-Business Sector Alliance for Investment Attraction, Innovation and Export Development" comparing the policies of restructuring and development in Ireland, Sweden, Finland, Spain, Canada, Czechia, Singapore, Malaysia, South Korea, New Zealand and Australia.

Coordinators: Robert Devlin and Graciela Moguillansky, CEPAL (ECLAC).

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[1] Charles University, Institute of Economic Studies; Academy of Sciences, Prague and Anglo-Americal University, Prague. Contact address: benacekv@fsv.cuni.cz.

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MISSION STATEMENT

The objective of this study is to provide a non-partisan and multi-faceted analysis of factors that brought a small country with opened economy suffering from a long-lasting secular decline and a crisis of its ideological integrity (1948-1989) onto an accelerated growth, rising competitiveness and a self-confident national entrepreneurship.

There are more details why the events of economic transformation of Czech Republic can be considered a success story: the country was able to absolve itself from a large part of its past legacies: those of State paternalism, all-embracing bureaucracy, rule of a single political party, discharge of entrepreneurial independence, functional autarchy of its trade and a decline of R&D in their products. The ascent of transformation was impeded by the backlash of two recessions caused by a *volte face* in policies aiming at new strategies in development that targeted two parallel objectives: efficiency of the market system and a social harmony. The task required to open the economy to a profound restructuring guided by market signals supporting the strong, meanwhile the new institutions of social governance had to protect the losing parties from a long-run marginalization.

The way up was far from being straightforward. Many of the policies and instruments used were conflicting and leading to blind alleys, however, the socio-political decision-making had its checks and balances and the gradual process of policy-tuning brought its fruit in a relatively short time. For example, the processes of trade diversion and new trade creation took mere four years, the restructuring of the pattern of specialization and its re-allocation towards high and medium technologies took approximately seven years. That required a re-switching from labor-intensive product mix to financial capital and human capital intensive production, which was accompanied by rising unemployment in the mid of transition. It took the system of social security seven years to overcome that burden of transformation and retain a high equity of income distribution and very low poverty rates. Though full of political controversies and suboptimal concessions, the final progress was brought by interactions of three key sectors of social decision-making where businesses, governments and households were forced to seek consensual solutions in their quest for a balanced development.

Basic indicators of the Czech Republic (2006):

Number of inhabitants:	10.3 million, comparable with (= c/w) Portugal, Cuba or Ecuador). Net immigration keeps the demography rising at a very slow rate (0.35%). Minorities: 3% Slovaks, 0.5% Germans, 4% Roma (unofficial estimate).
Surface:	79 000 km^2 (c/w Cuba or Benelux).
GDP in current USD	$ 134 billion in 2006 (c/w Venezuela or Colombia).
GDP in purchasing power parity	$ 212 billion (c/w Portugal or Chile, 2006),
GDP per capita	$ 13 035 in current $, c/w S. Korea or Trinidad, $ 20 563 in purchasing power (75% of the EU-27), c/w Portugal or Bahamas.
Consumer price level	63% of the US due to lower prices of non-tradables.
Share of agriculture on GDP	3.3 % (constantly falling)
Share of manufacturing on GDP	28% (unusually high and steady state)
Share of services on GDP	69% incl. construction 11% and trade 17%
Current exchange rate (Nov, 2007)	19 CZK/USD (i.e. Korunas per Dollar) 27 CZK/EUR (very stable in nominal terms, on a long-term appreciating path in real terms).

Remark: The country has two official names (political and geographic) – Czech Republic and Czechia. There is also the historical name of Czech Lands. We will keep them in this study as synonyms.

1. Transition as a Catching up in the Context of World History

According to Fukuyama /1992/, the fall of communist regimes (or more precisely their centrally planned economic systems) brought a watershed into human history. Even though the demise of the bi-polar world does not imply that humanity has entered its new history of harmony among countries or even among civic communities, it is certain that something qualitatively new has occurred. Indeed, the changes in the communist world in Europe and Asia, evolving at a rapid sequence of events since 1989, influenced fundamentally the development of the whole world. Civilizations in both the West and the East disentangled themselves from the risks of mass-scale military conflicts and could enjoy the peace dividend from conciliation. The search for an alternative to capitalism received a severe blow. Now all economically developed countries indulge in using capitalist organization and in building its institutions. A similar direction is followed by nearly all developing countries, headed by India and China. Even though it is obvious that capitalism of perfect competition is not that system, which we arrived at, it can be claimed that the **process of building globalized capitalism, that lasted for nearly 600 years, has been concluded**.

At least so it is according to János Kornai /2005/, the most distinguished East European economist, while referring to historical sciences. Because something very long-lasting has been concluded, we could come with a hypothesis that something new has been conceived. What should it be? We cannot expect naively that the history entered a period of a standstill marked by an eternal victory of capitalism. Capitalism itself evolves and its recent forms in Scandinavia, Ireland, Japan, India, China, Malaysia, Russia or Brazil are definitely very different from those ones of 1880 or 1970. They are even markedly different from the expectations of 1990.

We dare not say which "capitalism" is the correct one. We observe a multipolarization of socio-economic systems based on such institutions as consumer choice, private property, hired labor, globalized free trade, exchanges mediated by markets, world-wide flows of credit, and the legal system of contract protection and risk sharing. It was the fall of communism that facilitated this kind of world-wide globalization. All of these institutions, in contrast to an assumption that globalization converges into unification, are evolving towards **national multi-polarization**, offering **varieties of new forms of institutions** that are underpinned by new phenomena in urbanization, industrialization, commercialization and virtual services. The **fragmentation of production and consumer choice** are most characteristic features of modern economies – a complete opposite of presumed tendencies to monopolization and uniformity. The governance of corporations, nations, localities and households is also undergoing dramatic changes.

There were 33 countries that underwent post-communist transition that comprised over 1700 million people – a quarter of humanity. Each of these countries experienced its own approach to restructuring, thus applying a **multitude of national transformation strategies**. There were no pre-conceived policies for solving the task and the trial-and-error approach could not be avoided. Many policies led to blind alleys and had to be discarded. Gradually the fine-tuning of **transformation policies brought nearly all transition countries on a path of high growth**. Nevertheless, the accumulated experience also reveals that under fast growth many present policies are not sustainable and **a new generation of policies should be applied**. For example, Czech economy is now challenged by a necessary transition to a third generation of policies – i.e. the **policies of the knowledge economy**.

We can also observe that while there is no democracy without capitalism, the appearance of a capitalist economic system does not automatically imply the emergence of democracy. Nevertheless, the trend to parliamentary democracy, at least in its nominal forms, has been visible throughout the world after the fall of communism (Haggard, Kaufman /2005/). Kornai /2005/ concludes that post-communist transition was a unique event in the human history by both its scope and intensity. Its most surprising aspects were the unpredictability, the internationally transferred learning from others, unparalleled peacefulness, consensus to compromise, complexity of social changes and the high speed of economic transformation.

The Great Post communist Transformation thus opened a new quality in the history of social development, which had deep repercussions especially in the developing countries. Meanwhile the economic growth in many OECD incumbent countries even slowed down after 1990, the development in the rest of world speeded up, bringing the growth of the world economy to around 4% in the long-run. The growth rates significantly above 6% became sustainable for many emerging economies. According to Sala-i-Martin /2006/ the long period of doubts, whether the developing countries would be able to converge to the wealth of the OECD countries, has ended. At the same time some economies, many of them in Africa and Latin America, have not been able to catch up with new trends and their growth kept on diverging from the mainstream.

What can we learn from the fall of communism and central planning? According to the logic of Karl Popper, empirical facts that are consistent with a hypothesis cannot serve as a proof of the correctness of that particular hypothesis. Such facts could be just a mere coincidence of events where the interdependence of real causes was incorrectly presumed. The only hard proof we can have is when facts contradict (i.e. "falsify" and thus refute) the hypothesis. **The commitment to build an alternative to capitalism by means of central planning and the denial of private property was refuted as unacceptable (and thus false) by 33 countries and in none of them the change for a return back to capitalism was enforced externally.** The will for a change was spontaneous.

At the same time we cannot use this outcome as a proof of the "correctness" of capitalism in industrially developed capitalist countries prior to 1990. Expressed more specifically: although on one hand the fall of communism is not a verification of the "historical rightfulness" of liberal/libertarian capitalism, it is clear on the other hand that "the creation of the socialist system was a deviation from the main direction" (Kornai /2005/). What we can see only is that socialist/communist system lost the race with capitalism during 70's and 80's; during 90's their empire transformed its rudimental and highly imperfect market economies into a dynamically growing (though still imperfect) market economies where the idiosyncrasy of path-dependency could not be avoided. In addition, the developments after 1991 make it obvious that **capitalism as a global system kept evolving,** acquiring new forms world-wide. As a result, 33 post-communist countries, joined by some other important developing countries (India, Mexico, Brazil), entered quite self-confidently into the orbit of globalized capitalism.

We cannot separate the fall of communism from the globalization. They both modified fundamentally the international political, social and economic setup. The inability of some large countries (France, Germany, Japan and partially the USA) to react flexibly to arising challenges brought their economics or politics to a conflict with the rest of world. Learning from what happened in the advancing transition countries can be important from the following reasons:

- These countries had to revamp their industries from the grassroots. Often they had to abandon widely built industrial estates and to start again from a scratch with different people and different resources.
- Their restructuring of industries had to go in parallel with the **restructuring of institutions and policies**. It became a matter of survival by implementing their new forms and contents, thus forcing the transition countries to abandon existing institutions, vested

interests and traditional government interventions. As an outcome, the choice of new solutions was subject to fewer constraints than what the advanced countries could muster.
- Transition economies had to become highly opened, adopting liberal laws and free competition, where international capital could locate its state-of-the-art technologies in an optimal environment. Offshoring and outsourcing became the vehicles of growth throughout the world.
- The government policies in transition countries had to be targeted at growth at the expense of the welfare state (at least provisionally) because of the initial harsh recession and the consensus among population to endure the belt-tightening.
- The split of economies into the traded and the non-traded parts became particularly pronounced in emerging economies, which required an implementation of **new two-tiered socio-economic policies**. Thus **the co-acting between the private and the public sectors had to develop new forms** that tended more to diversity and complementarity (partnership) than to rivalry.
- Last but not least, there were numerous experiments with most varied policies that were never seen before, which, by trial and error, were selected as winning or discarded as losing strategies [2]. Learning from failures to be avoided can be even more productive than learning from victories, which can be too specific.

The attraction of taking the Czech economy for a case study rests in a variety of policies that were applied in that country. Many of these policies were clearly structured, well documented and consistent with predefined economic paradigm. Some were libertarian, some were orientated at the social peace. Many of them failed and had to be either replaced or modified in several stages. Some became a success from the very start. Many policies, irrespective of being socially efficient or not, were challenged by the rent-seeking coalitions and the quest for a social equilibrium required lasting re-negotiations.

The Czech "success story" has been underpinned by policies leading to:
- **extremely fast diversion of trade flows from the East to the West followed by an accelerated creation of new trade,**
- **attraction of foreign investment,**
- **upgrading of product quality,**
- **break-trough in many high technologies with significant domestic spillovers,**
- **intensive deployment of small-scale entrepreneurship,**
- **sustainability of macroeconomic balances,**
- **very low level of poverty,**
- **functioning social safety net,**
- **speedy catching-up with the EU incumbents.**

Except to economic dimensions of success, there should be mentioned its other spinoffs: to the improvements in health indicators (such as the fall in the rates of exposure to mortal diseases and the clearly rising longevity), sharp decrease in pollution, booming sector of culture and the NGO activities. As this study is focused on policy-making processes that are directly and indirectly supportive of export development and growth, the philosophy of required "first principles" is often closely associated with the above mentioned objectives.

[2] For example, the history of policies known as "Washington Consensus" that were initially considered unimpeachable was such a case. Concentrating on restrictive macroeconomic policies and on an accelerated (and superficial) privatisation resulted neither in a fast growth nor in stable ownerships. Surprisingly, it was a gradual approach (such as in China or Slovenia) that led to a faster transition. Thus countries under the aftermath of "easy early victories" had to re-adjust again and concentrate on institutional revamping that became the true bottleneck of growth.

2. Czech Economic Policies from the Time Perspective

2.1. The Demise of Central Planning. Where Do We Come From?

Historical milestones:

1620-1918	Historical Czech Lands as a part of Austrian Habsburg Monarchy.
1918-1938	Czechoslovakia ("The First Republic") established as a democracy.
1939-1945	Czech territory under German occupation; Slovakia an independent country.
1945-1948	Czechoslovakia restored as a democracy with mixed economy.
1948-1989	Czechoslovakia as a Communist totalitarian state interrupted in 1968 by 7 months of "Prague Spring" revival.
Nov 1989	The "Velvet Revolution" and the re-establishment of democracy.
Jan 1 1993	Czechoslovakia separated, establishment of Czech and Slovak Republics.
Mar 1999	Czechia became a member of NATO.
May 2004	Czechia joined the EU.

The history of Czech economic development bears many parallels with the historical events in Argentina and Spain. Portugal, Chile and Mexico are also countries whose economic development, as emerging latecomers, are aspiring at catching up with the help of similar development policies: innovations and high international openness. Historical comparison of these countries is in the Appendix.

Prior to revolutions in 1848, historical Czech Lands were a backward post-feudal countryside, off the booming capitalist development in the Atlantic region. Though a late starter, its accelerated industrialization ended in a glamorous rise before the World War I. Czech manufacturing became a leader among the nations of Austrian Empire with business exchanges all over the Western and Southern Europe. After the gain of independence in 1918 there was additional fast growth driven by manufacturing exports that was severely checked by the Great Crash (1929-34). The subsequent loss of many traditional markets ended in 1938 by becoming a slave economy for the German war supplies. The short post-war economic enthusiasm ended in the communist takeover in 1948. The re-orientation of its trade to the East implied a loss of its competitiveness. The period of experimenting with planning reforms in 1963-68 ended in an invasion of Soviet tanks and in a "normalization" where the dogma of central planning was kept unreformed until the Gorbachev days.

Economic performance before the sweeping changes after November 1989 is described in Benacek /2001/. Some of the historical data are in Appendix 1. We can see that the competitiveness ranking of the Czech economy within the world context was sharply declining, notwithstanding the bubble of high growth provided by official statistics. There is a lot of misunderstanding how the communist economies performed. Czechia, as the most advanced of all communist economies in 1948, was particularly hit.

Digression 1: Why there was a bias in the GDP statistics of planning prior to 1990

A "success story" of any transition country cannot be complete if one does not consider correctly the depth of problems, from which these countries had to rise. The assessment of the Czech economy is particularly stricken by ensuing estimation bias.

If related to a common starting point since 1950, Czech central planning performed worse of all communist countries, especially in the field of international competitiveness. Nevertheless, there were still some confusing successes on the volume side of production. For example, Czechoslovak physical capacities in such industries like coal, iron, cement, oil refining, electricity, crude iron, trucks, aircraft, arms, etc., were often more than comparable with much more advanced economies in Western Europe. Taken per capita, Czechoslovakia was in some parameters a world leader – such as steel or cement output per capita.

Also the total employment and investment rates were among the highest in the world. The only fly in the ointment was that such phantom mobilization of factors, material inputs and arms generated extremely low value added in the subsequent stages of processing. The gaps in consumer goods and exports to free markets, if related e.g. to Austria, were sharply widening. The catch was in the pricing system – the centrally planned prices were purely cost-based, as the competition was completely void. Naturally, also the demand had to be artificial and forced. Only the prices of exports to the West could not be "planned". Their unit prices were trailing far behind the poorest OECD countries, with the terms of trade constantly falling. That required to keep the effective exchange rate ever more undervalued, which was reflected in the resultant extremely low GDP if estimated in nominal dollars.

At the same time even the most sophisticated international statistics of the UN and the World Bank did not figure out the bubble of the communist growth. For example, the estimates at the purchasing power standards (PPP) by Kravis et al. /1978/ or Summers and Heston /1988/ located the economic level of Czechoslovakia close to United Kingdom, and Hungary was assigned close to Italy [3]*. That would imply only a mild downward adjustment of the high official rates of real growth, as declared by propaganda in these planned economies. Until now many international evaluations of post-communist economies have not abandoned such a misleading base for comparisons because the backward adjustment of the communist data has not yet been systematically performed.*

The proof of the invalidity of the official communist growth rates in the Czech case is simple: Czechia in comparison with Austria in 1948 was more productive due to a lower war disruption. E.g. Good /1996/ estimates the lead of Czechia over Austria at 20-37%. The official growth rates in both countries were then until 1989 quite high and comparable. Thus Summers and Heston (1988), as well as Good /1996/, could indicate that the lag of Czechia behind Austria in the second half of 1980s was approximately by mere 25%. However, more realistic estimates of Butschek /1995/ point to the trailing behind at 50%. Even in the most optimistic case the Czech GDP per capita could not be higher than 55% of the Austrian level at the end of communism. To conclude, in the days of Cold War the West significantly overestimated the GDP figures of the communist countries. Since such overshot "official" data for 1989 were used as a benchmark for comparing the "recession" and growth during the transition period, the resultant poor performance of the post-communist economies during 1990s was a confusing erroneous outcome. ***GDPs in market economies and GDPs in central planning are qualitatively incompatible concepts****. The competition between them was not in official numbers but in consumer satisfaction. Only that explains why communism was so light-heartedly abandoned.*

Another lesson to learn is to understand how communist economies functioned and who were the agents orchestrating their demise. Unfortunately, as it was with the measurement of GDP, the Western economists accepted the official normative doctrines of central planning: those of a command economy directed from the top of planning hierarchy. Although such a notion described well the Stalinist and the war economies, the tenability of planning in peace-time required a more consolidated decision-making where the dialog between the upper and the lower levels of the hierarchy acquired the elements of bargaining, i.e. the elements of markets. The Party brass, their subordinate apparatchiks and the nomenklatura in enterprises could play various games for power and wealth, even though the

[3] E.g. *Summers and Heston /1988/ quoted the Czechoslovak GDP per capita at $ 9400 for 1985. Only the collapse of the planned system revealed that such a phantom GDP consisted of many products that had no real demand.*

lack (or ban) of supportive market institutions (e.g. the free prices) made the quasi-market bidding extremely inefficient (Brixiova, Bulir /2001/ and /2003/).

Therefore, communism was not completely void of both entrepreneurship and markets, as was often presumed in the West. There were also various strong players (see Benacek /2007/) whose motives for improvement did not imply the endless loyalty to the obsolete system. Theories that the real mechanism of planning was not based on macroeconomic command but on (often illegal) microeconomic bargaining, were developed in communist countries during 1980s. The literature pointing to the behavioral similarities between the market and the planned economies met with an official refusal both in the East and the West. The breakthrough coming with the volume of Quandt and Triska /1990/ came too late. After 1989 the world moved elsewhere and hardly anyone cared to learn how communism really functioned. The simplistic idea that communism was overthrown by the policies of R. Reagan, M. Thatcher and the Pope John Paul fitted the feelings of the presumed victors of the Cold War (Sullivan /2006/). It became an ideological image replacing the reality.

In reality the present success of the transition economies (e.g. those of China, Estonia or Czechia) was seeded already in the 80's in those very countries – it was the **craving for one's own property among producers and for a choice among consumers**. We should be aware that elements of markets are present in each society – the markets were present spontaneously also in the system of central command, even though its transaction costs were high, information channels weak and the excludability was often explicitly enforced. It was the omnipresent collectivistic impersonality and shortages of planning that called for the existence of an elementary implicit market mechanism that helped unofficially (or even illegally) with the final allocation of resources. It helped reduce the huge dead-weight losses and bring surpluses to individuals. Mechanisms of such rudimentary markets, which were both complements and rivals to central planning, were described by Kornai /1980/, Triska /1988/, Hlavacek /1990/, Mlcoch /1990/ or Brixiova and Bulir /2001/, /2003/.

It is obvious that planned economies had enormous institutional power for prolonging the Cold War or for suppressing the dissent. At the same time they lacked incentives to act so in the very long-run when the vast majority of actors would deplete their opportunities for further economic improvements. The outburst was possible only if the risk of violence or external intervention to domestic rule and mechanisms of changing ownership structures would not be present. Reagan, Gorbachev and Deng Xiaoping thus cleared that condition for a changeover, which was otherwise internally driven.

Centrally planned DON'Ts:

1/ Do not rely on dictators. The idea of an enlightened dictator fails in all "ordinary" situations. Dictators (planners) cannot be enlightened, except in extraordinary situations when there is a consensus that choices of the people can be sacrificed.

2/ Do not underestimate the powers of spontaneous collective actions. In microeconomic encounters the dictators (i.e. planners) are easily overpowered by the passive resistance (e.g. by voting by feet) of the people who share similar motivations, even though their organization is not explicit.

3/ Do not allocate any strategic resources according to official prices derived off markets. All regulated prices have their shadow utility price, which varies from zero (indicating a useless product) to a multiple of the tag price (indicating a product to be traded under-the-counter). Only these "prices" are relevant.

4/ Beware of the autarchy and its impediments to trade. In the long-run all its participants are worse off. The exchange rate regulation and the system of non-tariff barriers and implicit subsidies are in the core of incentives for trade inefficiency.

5/ The support of planned (regulated) monopolies is redistributional and wealth detracting in the long-run. A similar role is played by planning-generated information asymmetries that support rent-seeking at lower levels of the planning hierarchy.
6/ High state residual capture [4] leads to counter-effective allocations. Bottlenecks in the autarchy induce the state to invest into the weakest instead of investing into the strongest enterprises. Only the latter are natural drivers of growth in open economies.
7/ Do not plan centrally the R&D. Such a creative individual activity cannot be installed by decree. R&D and innovations are directly linked with entrepreneurship and with private returns as incentives to take risks.
8/ Parallel "markets" are omnipresent even in regulated economies. The shadow market economy (e.g. do-it-yourself, smuggling, illegal economy or haggling about the plan) rises spontaneously whenever free markets do not have chances for developing. Thus there is a clash of interests among the agents fighting for trade-offs between the functioning of such parallel economies, which cannot but operate at deeply suboptimal levels.

Centrally planned highlights:
1/ Planning is vindicated in the cases of wars or mobilization under a clear external threat – though maximally in the medium-run. It would still need a voluntary consensus building among its actors.
2/ Provision of some public goods (comprehensive education, pensions, primary healthcare and prevention are most admissible) can be managed by some instruments of command (e.g. by central planning), though even such **decision-mak**ing cannot function without free market signals.
3/ Planning is highly successful in bringing high rate of employment figures by introducing obligatory employment. Unfortunately, there is a high cost of a tradeoff between full employment and efficiency.
4/ Income and wealth equality, and implicit support of the weakest are a natural outcome of the economies lacking market incentives. They imply a shift to behavior of social cohesion and collectivism amid the resultant consumer scarcity.
5/ The central tenet of central planning is the rule of discipline and firm organization, which impresses outside observers who believe in the pre-determined nature of the world that is supposed to be known a priory.

As we can see, the social planning can easily turn its assets into liabilities whenever the narrow path of "highlights" deviates from the highway of decision-making that requires the consensual effort of the minds and hearts of all agents of the economy. The multi-polarized global world economy and the differentiated product mix thus made the central planning even more obsolete.

2.2. Policies in the Early Stage of Transformation (1989-92)

The most peculiar feature of the recent Grand Transformations throughout Europe and Central Asia (in contrast to China) was that there were no power coalitions organized at macro-political levels. Polish Solidarity was the only exception. Instead, there were long-lasting dissatisfactions of consumers with the lack of choices and of producers barred from building up a capital property of their own. The charge was in the personal feelings of nearly all citizens, accrued from the shortages in their daily predicaments of life, and not in the fuses

[4] In planned economies the state captured 65-80% of the GDP in various forms of taxation.

brought by the East-West rapprochement conceived by Andropov and supported later by Reagan.

The first principles of that early period were rather specific and implied the negation of previous principles (see the above Dont's). Hardly any capitalist country with poorly performing economy (let us consider post-Franco Spain) had to rise in the past from such a rock-bottom situation, which the communist countries found themselves in. The post-communist reforms in Europe can be compared with the extent of reforms needed in countries wrecked by war and followed by state debts, social unrest and macroeconomic chaos, though, surprisingly, none of these characterized the end of communism. The changes to be introduced seemed so demanding and so explosive that the first principles were initially reduced to three freedoms (i.e. social, economic and personal):

- to establish democracy by sustaining peace and social conciliation;
- to liberalize the entrepreneurial activities and to stabilize the macroeconomy in order to avoid falling into chaos;
- to defend human rights, freedom of choice and employment.

This actually implied the idea of a **Grand Alliance between the Citizens, the State and the Businesses** in an interaction with the globalized world. We can say that this simple principle and its extremely complicated checks and balances over implementation, have been the most revealing message that post-communist transformation brought to the world. Even though the post-communist transformation to capitalism is often interpreted as a victory of free markets where economic objectives dominate over all other issues, the real transformation in these countries ended with a powerful state sector (including strong public bureaucracy) and markets characterized much more by imperfections than unconstrained free competition. The resultant **amalgamation of three types of organizations of players** is definitely a system representing capitalism, however, its constitutional idiosyncrasy still bears the signs of its collectivist past.

Figure 1 depicts the performance of an ideal democratic capitalist society where all political requirements of its three functionally different sectors, its agents and organizations (i.e. those of firms, state and citizens) are balanced, while the needs of internal adjustments are evolving vis-à-vis the changing external environment. The requirements of citizens are in the base of the social organization where the enterprise profits and the public sectors serve as means of their satisfaction. The balance between agents is negotiated at the level of organized public polity – i.e. via political parties, social pressure groups and voices of the civil society. **The concepts of congruence of interest and the sharing of power among the private and the public bodies are of fundamental importance.**

However, their interaction and cooperation would not function properly without checks and balances that come from a third party: from the citizens and their organizations active in the space of public domain. The ultimate social objective function of both the private economy and the public concerns is therefore controlled by **open democratic governance** where political parties and NGOs play a crucial role. Otherwise the risks of private-public partnership would be exposed to the erosion caused by clientelism and state capture. Actually the total failure of the communist system was marked by colossal distortions of the balanced organization depicted in Figure 1. Czech policies of transition were therefore to a large extent influenced by avoiding to fall again into the trap of economics touted by unopposed politics [5].

[5] At the same time we should notice that such policies, pivoted on wide (volatile and often endless) public and political discussions, rebounded. They remained challenged by by attempts at reverting to past totalitarian customs of collusion among insiders. They could even prevail in the short run. However, the forces of democracy were nearly always able to take a regress on such arrangements and subject them to re-adjustments. Although such processes can take long and raise dissatisfaction among

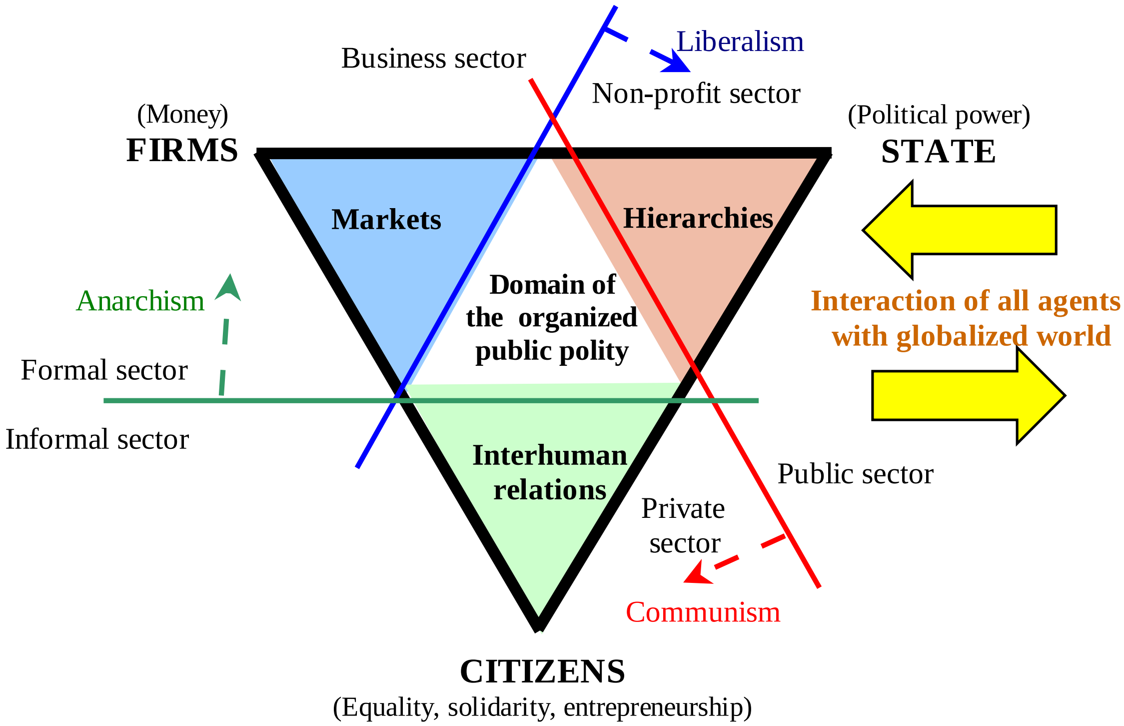

Figure 1: The triangle of socio-political pillars and the forces changing the scope of their dominance.
Source: Modified scheme of Pestoff, 1992, and Abrahamson, 1995.

In contrast to that, the communist system of organization was shifted by its balancing mechanisms (i.e. the planning) far away from the social equilibrium. Primarily the public sector expanded too far into the domain of both enterprises and citizens, as is illustrated in Figure 2. The nomenklatura in enterprises responded by using their monopolistic powers for controlling a part of the public administration. A similar self-defense was undertaken by citizens, whose informal networks of privileged pressure groups penetrated into the public sector. Thus at the end (e.g. during the Gorbachev's perestroika) both the informal private sector and the "business" sector infiltrated and undermined the domain of public administration. In Figure 2 it is shown by the green shaded area and the blue watershed line of enterprises infiltrating the area of real politics. It resulted in an opaque decision-making and in social governance lacking strategic leadership. In the second half of the 80´s it became clear even to staunch supporters of planning that its whole system was in havoc and in a need of deep revamping.

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citizens because the negotiations may protract for years, their direction was marked by the convergence to social consensus and to the minimization of social losses. Some pundits even say that even though such frontal openness of the Czech society was excellent in times of storms, we should always pray that it survived the times of "sunny weather". Indeed, such a political system has a built-in counter-cyclical mechanism, which actually is not so detrimental.

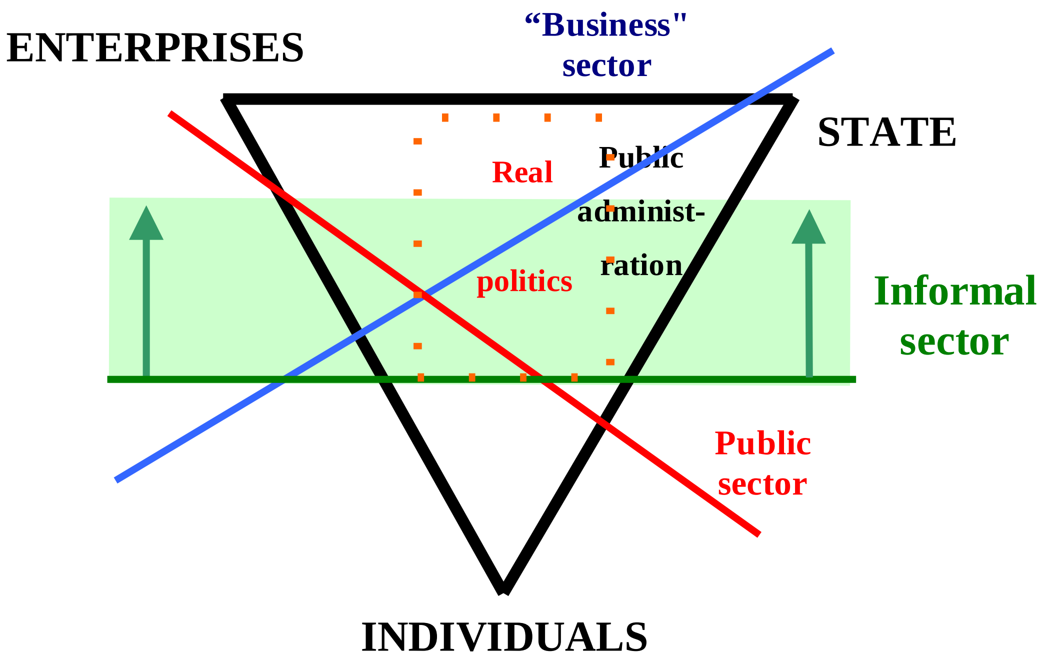


Figure 2: Erosion of the communist system before its fall: an informal opportunistic infiltration

Hand-in-hand with the expectations of the wannabe capitalists from the enterprise sector (the largest part of them were the communist nomenklatura), the velvet revolutions driven by the masses from the informal sector commenced to implement a sort of reformed democratic state-capitalism. The alliance between emerging new cells of civil society (e.g. via an enormous variety of political parties and pressure groups) on the one hand and enterprises transformed into joint-stock companies, whose shares were owned by the State, on the other hand, dominated for some time over the alliance between the public and the business sectors.

DO'S of the economic policies in the early transformation period required the formulation of some simple categorical imperatives. Such intuitive guidelines for policies were often derived mechanically: they represented the negation of the planning maxims. The list of DON'Ts from the previous paragraph points to such principles, even though their implementation often had to be postponed for later stages of transition. At the same time there was available the Washington Consensus – a ready-made toolkit the World Bank and the IMF, widely recommended by international institutions for mastering the transition to capitalism. This kit with policy-recommendations was derived from the experience of the World Bank with economic stabilization in disrupted developing countries. It offered policies fitting perfectly to the program of ideological imperatives. Its stress given to macroeconomic stability and only a marginal reference to microeconomic transformation via privatization and institutional revamping, offered a clear program for an immediate implementation that was neutral to clashing interests of pressure groups.

The best description of the Czech case – what to do and how to do – was formulated by David Begg /1990/. The early transition policies of the post-Soviet countries were born from a socio-political shock, where the introduction of democracy became top priority. That was a fundamental difference to the transition in China that was not brought about by masses of the informal sector. The Chinese way, orchestrated gradually by the Party nomenklatura, was therefore inapplicable in Eastern Europe. That natural political jump-start had to be gradually mitigated in order to stop its spillover into an economic chaos. Macroeconomic stabilization therefore temporarily dominated over microeconomic issues. The new governments discovered quickly that their powers to control over microeconomic changes were extremely limited. Governments therefore went into those fields where the control was effective: macroeconomic stabilization and long-term reform visions (Benacek, 1991).

Though the policy-making in transition countries was subject to many options free from external interventions (e.g. from other governments), very soon it was clear that effective changes could be reached nearly exclusively in the following list of eight specific policy instruments. It is necessary to stress that each of them was primarily designed to promote deregulation and competition.

The list of DO's in the first stage of transformation:

a) Fiscal policy – reform the existing excessive tax collection by cutting on its *ad hoc* features but retain sufficient fiscal revenues (i.e. over 45% of the GDP).

b) Monetary policy – stabilize the inflation by means of restrictive interest rate policy.

c) Exchange rate policy – bring the exchange rate "right", i.e. adjust it to the revealed losses of competitiveness (thus Koruna devalued nominally by 113% so that foreign exchange did not have to be rationed) [6].

d) Liberal international trade policy – open the economy to foreign competition, abandon immediately the state monopolies of foreign trade and repeal the quota system [7].

e) Liberalize the consumer prices, thus reversing the previous shortage economy of excess demand and introducing the consumer's sovereignty.

f) Labor market policy – repeal the policy of compulsory employment, freeze the wages in the state sector and liberalize the self-employment.

g) Competition policy – abrogate the state monopolies of production, liberalize the entry of entrepreneurs into the business register and allow the firms free entry into any industry.[8]

h) Privatization policy – even though the mass-scale privatization of state property was too demanding to launch so early, the institutions of privatization, property rights and contract enforcement were legalized.[9]

The ranking of policy instruments (a-h) is not at random. It takes into account the sequencing and timing of the operational availability of instruments, which in turn reflects their ranking according to complexity and thus their readiness to function as an efficient instrument for policy purposes. Since the primary problem of transient economies is to find a trajectory from the disequilibrium of command economy to a socioeconomic equilibrium of the market economy, each of the presented instruments should be earmarked for the fulfillment of two

[6] Later it was discovered that policies of instant equalization of foreign exchange supply with demand, practiced in many transition countries, overshot the exchange rate, whose pegging to stable international currencies brought an excessive inflation into the economy. Its pass-through into the prices of non-tradables and wages could not be stopped for next seven years.

[7] The communist extensive impediments to trade did not rely on tariffs. The system of forex rationing, import quotas and fiscal subsidies and taxes was extremely complicated. Once it was discarded, the new trade impediments (i.e. tariffs) became extremely low (below 4 % in average), which had to be compensated by excessive devaluation.

[8] The liberalization of competition policy in Czechia had to be later tightened in some specific industries. Regulation was re-introduced – e.g. in the financial intermediation – where nearly all new banks went to bankruptcy, hitting thus the savings of household and destabilizing the enterprise sector.

[9] As the share of genuine private sector on GDP increased from 1.6% in 1989 to mere 8% at the start of 1992, it was obvious that private firms could not become dominant drivers of the growth and efficiency, at least during the early stage.

economic tasks: first, to destabilize the institutional inertia of the command economy and, then, to safeguard the process of convergence to new market equilibrium. Each of them therefore has its own "shakeout" stage and its own stabilization stage. The list of reforms and even their sequence are very logical. The failure of any instrument in either of these two stages thus had to be balanced with the compensating effects of some remaining instruments - in the first place by those ones listed above that one in default.

It was the Washington Consensus that received the primary attention. The reason was its practical identity with the list of reforms necessary for making the economies capitalistic. As was discovered only later, it addressed the means of secondary order (though still extremely important ones). The catch concerned the functioning of the last three items in our list of DO´s and the devil was in details that were crucial for determining the economic behavior – such as the enforcement of property rights, contract discipline, reliable banking intermediation, institutions setting the rules of the game, etc. The problems of their implementation become apparent when we compare Figure 2 with Figure 1. Their systemic arrangement by boundaries between sectors is very different and it does not concern the economic sector only. Transition had to reorganize all its groups of agents. An order in the economy could not be achieved without reordering the public administration and curbing the informal sector: economics, politics and the social system are highly inter-dependent.

Washington Consensus did not account for the situation where real constraints of the economic system rested in all kinds of external institutions (social, political and legal), in their embedded incentives hostile to competition and in built-in barriers to "proper" microeconomic behavior. They were **neither self-enforcing nor self-sustainable and therefore they had to be socially contrived** (Stiglitz /1997/, Rodrik /2006/). That is a long-lasting evolutionary process based on consensus and countervailing negotiations among groups of agents. For example, importing institutions from outside and enforcing them by decree, as it happened in East Germany, were **not** an advantages as it was originally thought.

Looking back at Figure 2, we see that Washington Consensus did not address sufficiently the legacy of systemic distortions that the transition should solve in its three out of four sectors. These were the **enormous powers of bureaucracy embedded in the existing laws, the collusion between the state enterprises and the public administration, the informal network of Party nomenklatura whose relational capital did not lose on value as the Party was driven out of the Government and the executive powers the informal sector acquired before and during the "velvet revolution", which were often in conflict with new formal requirements**. The risks of such a system that got off handle in a hurricane of changes, became apparent as the languishing state enterprises were collapsing in a "pre-privatization agony": as their assets were appropriated illegally via "wild privatization" and as the workers' real wages were often cut by a half.

This was the weakest link among the policies of transition in all post-communist countries. The shortcomings in triangular partnership were thus marked by a sort of a traumatic hysteresis, at least until the beginning of millennium. **The ways how these pitfalls of transition were gradually overcome by government policies became some of the highlights of transformations in Central and Eastern Europe.** It was a process of self-discovery and entrepreneurial learning by trial and error in loops of renegotiations between the public, civic and economic sectors. There have not been many parallels in the history where negotiations and interdependences between these sectors would be so intensive [10].

[10] As the inter-dependence between private and public sectors in transition countries is one of their systemic features, so are the pros and cons of that relationship. It facilitates to exercise sophisticated development policies at scales hardly possible in socially sensitive advanced economies. It also can plague the economy with cronyism and corruption that stalls the system of checks and balances for learning from mistakes. The portability of such cooperative policies must be therefore taken with caution and in broader nation-specific framework.

Even the most libertarian governments (like those in Czechia, Poland or Estonia) were deeply immerged in industrial policies (explicitly of implicitly) because the real transformation issues were neither politically neutral nor self-contrived as a boot-strap lifting.

Conclusion: the efficiency of all socio-economic restructuring depends primarily on changing institutions, which have to be adjusted by collaboration of three sectors: public, private economic and private civic. Reaching their harmony and alliance is subject to long-lasting negotiations, which must be sheltered by politics.

Digression 2: Why economic policies in transition must be different from policies in stabilized developed economies and why industrial policies are indispensable.

Politia: primum est non nocere.

Going back to the issue of policies enlisted in the DO's above, which are built on, but extend above, those ones of Washington Consensus, it is apparent that they widely differ from policies used in stabilized market economies – i.e. the fiscal, monetary and (rarely used) exchange rate policies. The policy target variables, as required for a progress in transition, are primarily focused on the Herculean task of fundamental ***reallocation of resources****. The objective of macroeconomic balance (such a controlling inflation or external equilibrium), so typical for advanced market economies, can be of secondary importance only. Transition countries must also resign from palliative Keynesian policies keeping their unemployment low and short-run growth high. Their policies should target and eliminate the* <u>*causes*</u> *of their malaise.*

Tinbergen /1952/ formulated the problem of policy choice by the following vector equation:

$$\{\mathbf{Y}_t\} = \mathbf{\Phi}(\mathbf{Y}_{t-1}, \mathbf{P}_t, \mathbf{P}_{t-1}, \mathbf{X}_t, \mathbf{X}_{t-1})$$

where:

$\boldsymbol{Y_t}$ *is a set of target variables characterizing the objective functions followed by policies.*

$\boldsymbol{P_t}$ *is a set of policy instruments selected for the achievement of objectives in* Y_t*. There should be as many policy instruments as there are targets.*

$\boldsymbol{X_t}$ *is a vector of all exogenous variables characterizing the economy.*

t-1 is the index of time lag pointing to a path-dependency of development and policies.

The feasibility of policies is given by a set of policy constraints $\boldsymbol{\beta_t}$ *which define the normative criteria laid on the objectives:*

$$\mathbf{Y}_t \in \boldsymbol{\beta}_t$$

The problem of policies in transition countries rests in the length of the vector of targets $\boldsymbol{Y_t}$*. In contrast to stabilized market economies the list is much longer and, except for standard macroeconomic targets (low inflation, external equilibrium and employment), it must contain variables regulating microeconomic efficiency, income equality, transformation of ownership, fairness, low transaction costs of contracts, etc. Therefore also the list of policies P must be at least as long. Some of the policies are quite non-conventional, such as the establishment of new institutions, laws and bodies of governance.*

This is quite natural because in normally functioning economies the microeconomic sphere can be exempted from social control and from centrally guided policy-making. The accommodation of the microsphere and its supply side could be left to their own gradual evolution under the guidance of well functioning markets and entrepreneurs. Dramatic changes in the microeconomy of advanced market economies, as well as their institutional setup, would be there neither expected nor necessary. However, exactly the opposite is the sine qua non of the changes in emerging transient economies! Without concentrated social pressure on evoking changes in the microeconomic grassroots and especially on their supply side, the emerging heterogeneous class of entrepreneurs would not be able to overcome the built-in *institutional inertia safeguarding the survival of old local alignments and old productive structures.*

In transient economies, the leading objective should be to abandon the philosophy of keeping the institutional arrangement unchanged. Because economic institutions are neither self-contrived nor self-enforcing ***the first task concerns the introduction of new institutions offering new incentives****. The next task is* ***to restructure the microeconomic supply-side****, which is challenged by sunk costs and questions about who will bear them. Next there are information failures about the existence and the costs of alternatives, and the coordination failures for getting on a new path of supply chains and marketing chains (Rodrik, 2004: 8-14). Therefore the* ***quality of the supply side becomes the prime object of policy interventions****.*

So finally we came to a very important link between the economic policy-making and the urge for deep microeconomic real ("hard") changes, which are mediated through coordinated institutional ("soft") changes. Some specific policy targets can be stressed: schemes for eliminating corruption, institutions for guaranteeing the efficiency of corporate governance, schemes minimizing contract breaching, low transaction costs of entrepreneurship, efficiency of innovations, instruments of risk-sharing, harmony of interpersonal relations in the workplace, provision of public goods, the rule of trust, etc. None of such policies can be neutral to all industries and to all economic agents. Their benefits and burdens are not distributed uniformly among them, which makes such policies to acquire the nature of industrial policies. We should rather call them development or restructuring policies. The majority of them cannot be simply imported from outside because they deal to a large extent with behavioral patterns that are too idiosyncratic to specific stages of national situations.

Policy highlights of the first stage of transition in the Czech Republic

Czechia became very soon a leader (trailing just behind Hungary) in the speed, width and depth of reforms that became later standard in all European transition countries. What concerns the points a) through g) from the above list of DO's, practically all of them were completed before the end of 1991, i.e. during mere two years. The **decline in the GDP by 13.2% during 1990-93 was actually exceptionally low**, especially if we consider the intensity of reforms. It was the second lowest after Finland (-11.7%) and reflected the frictional structural changes only. Approximately two thirds of enterprises were without profits and a half of these was expected to close down within 2-5 years if they do not find a strategic partner. Helped by the real exchange rate depreciation of 48 % in 1991, the exports massively diverted from the East to the West. Its growth rate in nominal domestic currency until 1994 was 26%, when the rest of the economy scored just an inflationary nominal growth of 16%.

Although nearly all enterprises downsized their employment staff, the **average unemployment rate until 1996 was mere 4%**, the lowest from all transition countries. The perfectly stable nominal effective exchange rate for 1991–2001, combined with macroeconomic stability, helped the ascent of new enterprises. High shedding of labor was combined with **booming self-employment** and the rise of start-ups of small firms (up to 50 employees) on green fields. Table 1 illustrates the dramatic changes in labor employment that occurred after 1990.

Table 1: Structure of firms in the Czech economy 1990 – 2006
by January 1 of the given year (in thousands)

INDICATOR:	1990	1991	1993	1996	2000	2006
All registered firms	19	179	1119	1321	1963	2388
Physical entities (self-employed)	17	124	983	1001	1426	1681
State enterprises and institutions	1.6	3.5	3.3	2.2	1.2	0.7
Private firms and corporations	0.5	5	39	113	188	257
Joint-stock companies	0.043	0.7	4	8	13	17
Firms with limited liability	0	3	32	131	165	222
*Firms with foreign owners	0	0.5	9	35	81	131
Unemployment rate in %	0,8	4,1	2,6	3,9	8,6	7,3

Source: Statistical Yearbooks, Czech Statistical Office, Prague, 1992-2006

The **high mobility of labor** was facilitated most by **lifting nearly all regulatory and bureaucratic impediments on establishing new businesses**. There was also introduced an accounting relief for SMEs, investment tax credit and tax breaks for the start-ups with less than 26 employees. The ease and optimism it generated resulted in such accelerated rise of sole proprietorships and self-employment that Czechia became a leader among other transition countries and the unemployment rate was exceptionally low. Actually **the rise of small entrepreneurs was an achievement of paramount importance for the whole period of transition** [11].

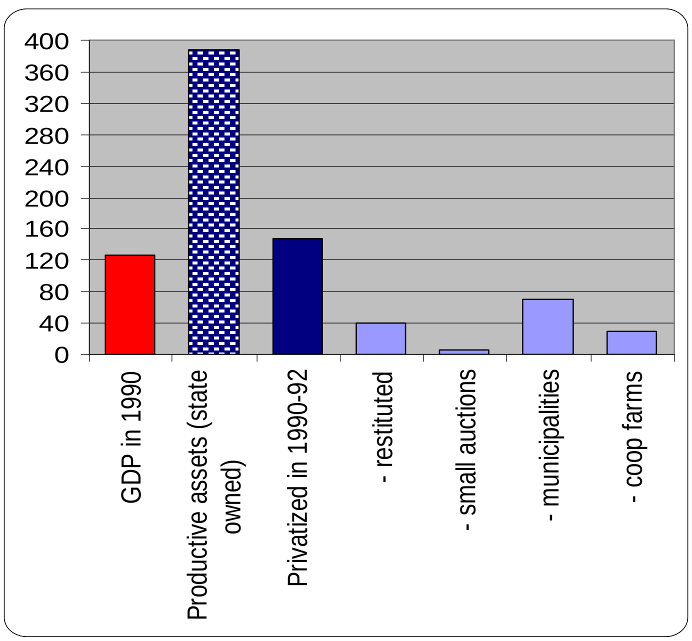


Figure 3: The "small" privatization scheme during 1990-92
(values in billion US $ adjusted to purchasing power parity of 1990)

[11] As the SME relief schemes were called-off in 1993 and the bureaucracy over income tax, social security and health insurance and newly introduced value added tax fell on the employers, so the flexibility got lost and the number of self-employed begun to stagnate in the next 5 years. The government support policies switched since 1993 to massive bailout schemes for large enterprises in mining, metallurgy, heavy machinery and banking. Only later it became apparent that such policies were counter-productive.

With the rising risk of asset stripping of state-owned enterprises (SOEs) by various shadow spin-offs, the government expediently opened the **Small Privatization Scheme** (Figure 3) that allowed in one of its schemes public auctioning of a part of the assets (machines and buildings) of state enterprises. Although its sales represented less than 2% of the assets controlled by the State, it was most probably the most efficient part of the whole privatization scheme. This small jumpstart initiated the series of most revolutionary steps of transition associated with privatization. It required an enormous courage of the democratic government to offer is "own" capital assets for privatization, whose value was treble of the GDP. It took 10 years to bring such an unprecedented privatization to a formal completion Nevertheless, its long-term effects on debt redemption and legal regresses are expected to burden public administration for another 10 years. **In all cases the nature of privatization influenced deeply the contents of public-private co-operation and the forms of development policies in the long-run.**

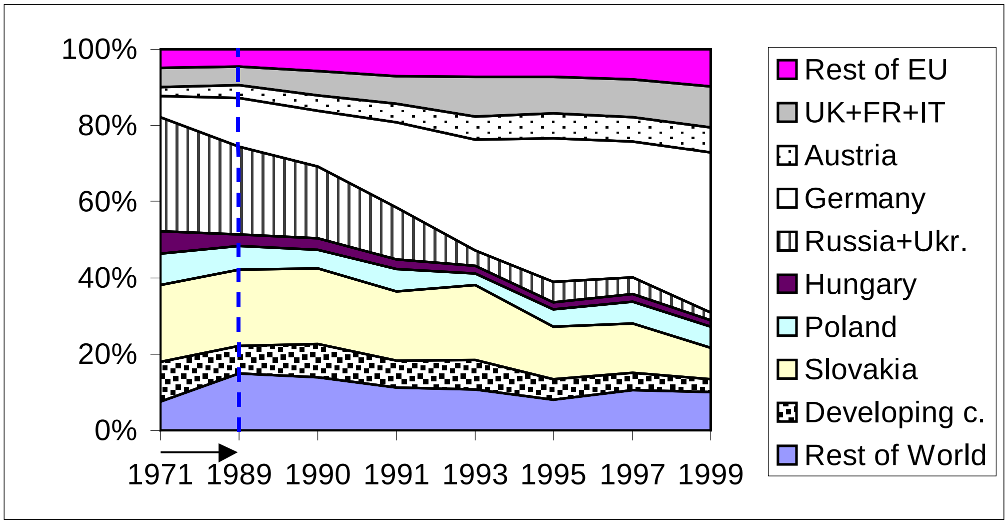
Another highly successful early privatization scheme were the **restitutions** to heirs of owners, whose property was nationalized after the communist coup in 1948. Their amount was 12% of all state productive assets. If these two surprisingly smooth and generally transparent schemes continued and extended to a part of divisible property involved later in the unorthodox Mass-scale Privatization Schemes (valued at $ 242 billion adjusted to PPP), the results of Czech privatization would bring more productive results. The expansion of SMEs occurred even without special government schemes – such as supporting the access to credit lines from banks and any special state subsidies that were later used for the privatization of SOEs.

The success of the transition of 1991-1993 was so persuasive that the government decided, contrary to successful schemes launched in Hungary or Estonia, that further privatization will proceed without any policies or support schemes given to foreign investors. Further development was intended to be based predominantly on the "Czech way". This was a policy contrary to the encouraging results from the pilot project tested by the takeover of Skoda Auto by Volkswagen in 1991. This accidental decision (causing a conflict in the government) had later crucial effect on export restructuring not only in Czechoslovakia but also in the whole Central European region that was bound to become one of the world's most dynamic agglomerations of automobile industry.

The last achievement of paramount importance was the diversion of trade flows (see Figure 4). In 1989 73% of trade exchanges were with the block of politically allied countries of Comecon. Exports per GDP was mere 46%. Hamilton and Winters /1990/ estimate the future trade flows by gravity model and claimed that Czechoslovakia had a trade potential under given GDP for doubling the existing figures in exports from $ 16 billion to $ 31 bil., while exports to the EU should increase ten fold. Though hardly anyone could believe the viability of such an expansion (until 1990 Czech exports to the OECD countries struggled with any increases), the need for a diversion was widely acclaimed. Koruna was nominally devalued in three quick rounds by cumulative 113%, which in real terms was 42% in 1991 and the wages were frozen. Although the terms of trade losses were over 10%, the trade diversion from the East to the West was practically completed in 1993 (Figure 4) and since 1995 the drive for dramatic gains in export prices reverted the past trends.

In 15 years since 1992 the real value of exports increased more than five fold. If there is anything like a real success in the Czech economy, it is the complete metamorphosis in the competitiveness of its exports.

Figure 4: Geography of Czech exports during the period of trade diversion.



Source: Trade statistics, Czech Statistical Office, 1973, 1994 and 2000

Digression 3: On the causes of output decline and the spinoffs of transformation policies

Figure 5 depicts the growth path of some transition economies of the central European region. In contrast to the EU-15, their growth was marked by a decline called J-curve. According to official figures, none of these countries has managed to overtake the EU-15 in their cumulated growth, even though EU-15 economies grew at exceptionally slow rates. Some highly successful economies (such as those of three Baltic countries), whose economies bear hardly any resemblance to the poor standards of their communist past, have not managed officially to reach the level of 1989 even after 15 years of intensive growth. The cause is in the sharp decline of output immediately after the inception of rational economic deliberations about resource allocation.

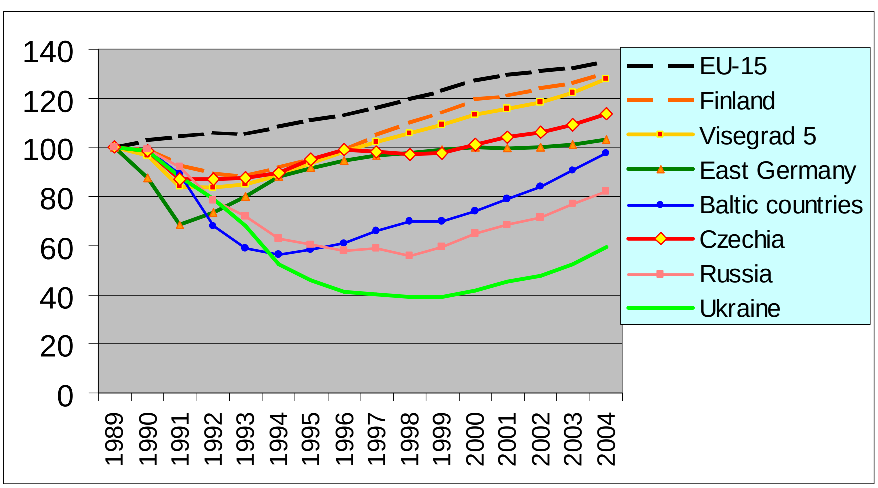


Figure 5: Trajectory of growth in transition countries and the EU-15

There is something weird in such statistics. Humans generally do not destroy their fortunes without a cause. We have also commented in Digression 1 about the myth of communist efficiency, as measured by official statistics of GPD in purchasing power parity. Thus the starting point itself is a virtual entity. Also the decline is often interpreted superficially.

In the Czech case we could see four main channels of losses after 1989. The first important loss was due to high openness (the value of exports was proportional to 41% of the GDP) and an inevitable trade diversion. The reorientation of nearly a quarter of the GDP to new unknown markets resulted in a sharp decline in export prices. However, in mere three years (1991-93) Czech exports were reoriented from East to the West and their price recovery could proceed.

The secondary source of losses came from the exchange rate overshooting in devaluation, which was deemed necessary (what was most probably a misjudgment) for keeping the trade balance in surplus and the workers in factories. That happened, indeed, even though their full employment in unrestructured state enterprises was often a social altruism. Undervalued real exchange rate, when wages did not adjust upward, caused a further loss in the terms of trade and increased import prices cut on aggregate demand in the consumer sector.

The third loss came from production reallocation to new products with higher demand, where the productivity per labor temporarily declined. Therefore also the total product of this part of population had to decline slightly. It is a natural effect of decreasing returns if capital remains fixed and labor increases. With the marginal product of labor falling so there was a pressure to keep real wages down. However, the aggregate demand loss from this side was compensated by rising profits.

The fourth channel of GDP decline was caused by rising unemployment, plus by a decline of labor that retired to household services. In contrast to many other transition countries this factor was quite mild in the initial period of transformation: until 1996 the average unemployment was 3,2%. Thus the overall decline in the GDP during 1990-93 was mere 13%. Until 1997 Czechia was considered a champion among all transition countries. The situation, however, was not sustainable. The quality in the depth of restructuring could not be compensated by some excellent macroeconomic indicators.

2.3. Policies in the Middle Stage of Transformation (1993-97)

The characteristics of this period was a rise in self-confidence of the government, since the macroeconomic stabilization combined with the success in Small Privatization Scheme and the spontaneous rise of entrepreneurship resulted in a sharp growth of 1995. It was claimed that Czechia could be the first country to opt for euro (ECU at that time) immediately. Unfortunately, the microeconomic core of the economy was far from being ready and the race for privatization championship resulted in a collapse.

The mass-scale privatization schemes of 1992-96 became famous for its two voucher schemes (see Figure 6) and equity shares distributed by bidding among the population. The scheme brought no capital to enterprises and the management passed to the hands of colluded investment funds who became agents of individual shareholders. The accountability of agents lacked clear rules and the unorganized powerless "principals" were gradually stripped of their assets. That would not be such a social problem as was the governance of corporations managed by investment funds. It was evident to them that restructuring of former SOEs would be a slow and demanding process, whose yields would have to be spread over the millions of passive shareholders.

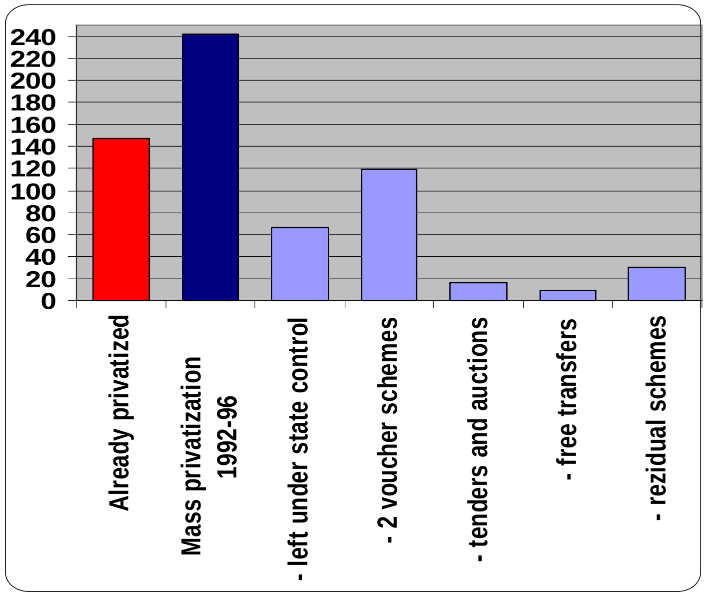


Figure 6: "Large" privatization scheme during 1992-96
(values in billion US $ adjusted to purchasing power parity of 1990)

The easier alternative was the asset stripping that acquired the nickname of "tunneling". Although this is again a serious moral problem, there could be a silver lining of this cloud would such assets be transferred easily into new efficient businesses. But this was the fly in the ointment! The antiquated capital sunk in industries without comparative advantages, managed by opportunistic agents and left without new capital injections could be hardly converted into new competitive firms. Their exit could have been potentially postponed by government schemes (such as industrial policies, accelerated depreciation schemes, tax relieves or better legislation of bankruptcy, contract enforcement and liability for debts) so that at least a part of the physical assets would have been recouped. However, this was not the case.

Even though looking at the Large Privatization from hindsight may occasion a scorn about its outcomes, we should be aware that mastering it better was beyond the powers of any government at that time. The first round (Small Privatization) dealt with less problematic assets and Czechs, at least, tried to make also the second round transparent [12]. It did not finish so at the end and a subsequent wave of re-privatizations during 1995-1999 had to bring the shaky ownership structure to accord with effective governance. That was neither a transparent nor an efficient process of capital concentration and the government had to intervene again with massive stabilization schemes.

In order to help the restructuring of former SOEs, Czech government did not privatize the banks during 1990-97. The National Bank upheld an expansionary monetary policy and the Government instructed the banks to support the privatized enterprises by generous credit lines. The result was that commercial banks accumulated bad debts equal approximately to the value of assets privatized by both voucher schemes ($ 119 bil. at PPP) and had to be

[12] Also in other transition countries the mass privatization went off handle and the assets were distributed either spontaneously or among the circle of political insiders and other powerful stakeholders. We can hardly assess in which method the balance between its costs and benefits was more constructive. Czech scheme, however, had one advantage: it did not lead to a sharp increase in inequality among the population.

bailed out [13]. Ministry of Finance assessed a part of those costs, associated with the resuscitation of the banking sector alone, at 21% if related to the GDP value of 1998. This kind of hidden government debts is very dangerous because of their shor-term disbursement. In addition, they open the space for a loss of banking credibility, a run of households and creditors on banks and a collapse of the whole economy. The government intervention by bailouts is the only way out.

There were various techniques used for subsidizing – by direct compensations of strategic enterprises from the treasury or by using "extra-budgetary" funds, such as the revenues from privatization and the seigniorage accrued to the National Bank. There were also implicit subsidies: tax remissions, unpaid wages, social security and health payments, waiving of payments for privatized assets or sales of property to private owners below the market price. Even though the official state aid from the Treasury during 1992-96 did not raise much attention [14], the extra-budgetary support was significant, plus there were instruments of the mentioned implicit industrial policies that made the subsidies incomparably higher than what was the practice in the OECD countries. The hidden government debt was looming and it had to be disbursed sooner or later.

The problem, however, was not in the extent of state aid but in the inefficiency of subsidies, which actually motivated the firms to postpone restructuring and indulge in moral hazard or asset stripping. At the same time the government rhetoric was that Czech liberal economic strategy eliminated completely the usage of industrial policies. For example, there was officially no support of FDI by a system of incentives. The asymmetry of factual interventions was biased nearly exclusively towards a "graceful restructuring" of large former SOEs, intended mainly as a precaution against unemployment. Indeed, the unemployment rates until 1996 were around 3,5%, while in other transition countries they were minimally the double of that. The hidden bias in such "implicit" industrial policies supporting the SOEs was in the discrimination of both SMEs and foreign direct investment. We can brand the policies of 1992-96 as typical "picking of the losers" who, indeed, proved to remain losers even after the injections of amalgamated explicit and implicit subsidies reached the value of more than a half of the GDP [15].

All these policies that were not targeted at the causes of problems but at relieving the effects of radical reforms, brought the alliance between public and private sector closely together. Unfortunately, during this stage their pattern and objectives represented examples how such alignment can be myopic and counter-productive. The growth that accelerated during 1994-95 had to be halted by restrictive macro-policies (due to deepening external imbalances) and property rights encroachment litigations. The winners of the asset stripping speculations were the entrepreneurs prone to moral hazard and fraud. It implies that given superficial interpretation of liberalism ("market game without rules") generated an adverse selection bias in picking new business leaders who, in addition, preferred often to channel such gains to tax havens and to use them for consumption.

[13] Please compare the magnitude of these problems of a small transition country with rickety economy and rising unemployment on the one hand, with managerial defaults such as Enron or Parmalat that occurred in large rich countries. The social burdens of transition costs were incomparably higher in the former countries.

[14] Taken from the formal point of view, the budget was balanced and the expenditure on subsidies was e.g. 3.1% in 1995, while it was 19.3% in 1989. However, some budget expenditure remained as high as under communism: transfers to the population were 19.4% and investment expenditures 7.6% (data from IMF statistics, as quoted by Coricelli, Dabrowski and Kosterna, 1997, p. 29).

[15] A similar observation can be made of the subsidies granted from the West to East Germany. There the magnitude of public injections to the enterprise sector reached EUR 700 billion. In per capita terms the German scheme was approximately 20 times more generous than the Czech quite generous public relief schemes, without making East German firms more competitive.

The reluctant approach of speculative *noveau rich* to productive entrepreneurship is known from developing countries, too. The policies of Czech governments changed dramatically after 1996. The stress was given to gradual reforms and concentrated on the incentives to entrepreneurship. It required to overhaul the legal system for strengthening the enforcement of contracts and property rights, and to design explicitly stated restructuring policies. **The break-through came with new industrial policies targeted at the attraction of foreign investors**. **This agenda was assigned to CzechInvest promotion agency that became the leading interface between the government and enterprises**, for which it acquired later an international acclaim. Its functioning is described in detail in the appendix of this study.

List of DON'Ts in the middle stage of transformation (1993-97):

1/ Do not overestimate the powers of the government once the initial stage of transition was better than expected. Economic success is not always due to the existence of governments.
2/ The conceit of human engineering without feedback from the battleground may drive subsequent reforms astray.
3/ Privatization is a policy that tampers with one of the strongest urges of human nature – the greed. It can easily turn against its masters if the checks and balances are not present.
4/ Do not expect that behavior of agents is determined by mere macroeconomic stability. Economic environment is in balance when businesses, public administration and citizens are all coordinated by common rules of the game that reward productive behavior, restrain rent-seeking (redistributive) tendencies and punish destructive behavior.
5/ Do not neglect the re-adjustment of incentives built in institutions such as legislative, fiscal and social safety net frameworks.
6/ Do not bet on the resurrection of old incumbent firms sunk in the mire of past privileges and developed on bygone comparative advantages. It is the start-ups on green fields that have the vigor for growth, notwithstanding their present small size.
7/ Do not abandon policies that proved to be effective. Opportunistic politics is the main wrecker of success.

List of DO's in the middle stage of transformation (1993-97):

1/ Macroeconomic therapies for stabilization by shock are not risky if there is a consensus among people that a short pain of surgery will bring a recovery soon. Political partnership with the electorate is in the core of success.
2/ Privatization by shock, in contrast to a gradual takeover of old inefficient enterprises, is definitely a risk in the need of hedging that would strictly control the property rights and contract enforcement.
3/ The build-up of the institutions of prudent finance should become a priority. Transfer of banks to owners who would not risk a loss in prestige implies that the ownership of banks without a perfect corporate governance should be entrusted to foreign owners. Even very high costs of the revamping of banks will prove to be an efficient investment into the future.
4/ SMEs should receive a special support in their development. They are easily hurt by market imperfections, lobbies of corporate giants and flaws in contract enforcement. SME start-ups are the most dynamic and most adaptive part of the economy.
5/ Legislation and judiciary that stand by contract enforcement and that bring low transaction costs of economic cooperation are necessary conditions for economic transformation.
6/ Emerging markets during transition are rife with imperfections that are easily abused by market leaders. Government policies should observe such failures and help by coordinating

support schemes for their removal or bypassing [16]. Not all markets are self-enforcing, the majority of them are man-contrived and subject to externalities that private agents can hardly provide alone. Such important modern markets as those for contracts of future deliveries, risks, innovations, public information and institutions function more efficiently with the help of government intermediation and surveillance.

7/ Traditional direct industrial policies (such as the "helping the losers" or "picking of winners") open the door to moral hazard. Alternative indirect policies are more productive, such as defending the market discipline (hard budget constraint, pro-investment climate and support of fringe competition) or encouraging the agents to enter or implement an innovation by relieving their transaction costs on such a path.

2.4. Policies for the Completion of Transformation (1998-2002)

Until this stage was reached, the transition economies and their indigenous agents are on the one hand too weak to withstand alone the globalized competition of oligopolistic markets. The infant industry argument would say that government support in underpinning the enterprises in temporary infirmity is justified under clear-cut rules. On the other hand, many of restructured firms are now ready to learn from competitors, establish alliances with them and become a part of world networks. Now the society should step out of the period of underprovision of entrepreneurship in pursuit of structural change and innovation. Role of the government should shift towards encouraging enterprises in an assault towards market penetration. According to the principles of modern industrial policy (Rodrik, 2004, or UN ECE, 2007) the first barrier that catching up economies should overcome are the **impediments to the imitation of technologies and techniques of market penetration**. Indigenous firms must be in closer contact with world competition and policy makers must have closer relationship with the targeted firms in order to **elicit correct business information from them**.

There is another side of the coin to policies facilitating the path of enterprises for becoming future winners – **what to do with the losers?** Should the losers be written off? Are there no externalities of redirecting them onto the path of winners? Is there a need for aid and coordination?

In 1991 the Czech government founded Consolidation Bank (later renamed to Consolidation Agency) in order to channel foreign debts payable to state banks by former communist allies off to special accounts, so that their settlement would be more efficiently negotiated by a government institution. Securitization and auctioning of debts is a good servant of risk management in an environment of developed financial sector and performing judiciary. However, without their support it had to be the State who took over the role of a financial fireman that relieved the burden of emerging private sector. Nevertheless, it was not expected that after 1997 this agency will have to take over a different type of new debts – those of these rehabilitated banks. Their non-performing credits ("bad debts") represented in 1998 34% of the portfolio of credits, reaching $ 15 billion in 1999. Inefficient paralyzed banks had to be privatized to financially strong owners. Such investors could be found only abroad and would come only if the reclaim of debts would not be burdened on them. Thus the government had to intervene and relieve banks of these negative "assets" through another

[16] Sometimes an enormous progress can be achieved by low-cost interventions. For example, in a situation of widening indebtedness private institutions alone are not able to produce a common list of debtors (a positive externality) who default their obligations: there are too high private transaction costs that are externalised by free riders. Government coordination can facilitate it so that negative externalities are eliminated and positive externalities are benefiting all stakeholders.

round of debt relief via Consolidation Agency and bailouts. The efficiency of debt reclaim was extremely low – the yields above 10% were considered a success.

Restructuring and privatization of banks was a strategic policy of paramount importance that determined the nature of government policies in the next six years. The plan practically determined not only an explicit subsidization of banks but also an implicit subsidization of enterprises with largest debts to banks. This is again a recourse to industrial policies, i.e. to policies where incentives/relieves to economic agents are not offered in a market-neutral way. Industrial policies imply the existence of a visible hand. In this case the beneficiaries picked were large debtors. The government had no better option.

At the same time the years of 1997-2003 were the years of negotiations for the EU accession. The outcomes of negotiations improved significantly the efficiency of this otherwise counter-efficient state bailout program because the acceptance of ***acquis communautaire*** (i.e. the EU laws) included a fundamental revision of existing legislation of property rights and contract enforcement. Subjecting domestic "visible hands" to more impartial criteria ordained by international bodies increases their efficiency.

Table 5: Public aid expenditure of the government in 1997-2003 (in $ million)

Sector of intervention:	**$ mil**	**%**
Restructuring of the financial system	8905	61,5%
Transportation	3141	21,7%
Mining	827	5,7%
Small and medium-size enterprises	433	3,0%
Support of investment	311	2,1%
Research and development	305	2,1%
Agriculture	239	1,7%
Support of exports	153	1,1%
Regional development	85	0,6%
Environment	34	0,2%
Sundries	42	0,3%
TOTAL	**14475**	100,0%

Source: Zemplinerova, 2006, p. 209.

In average for 1997-03 the annual expenditures on enterprise support schemes represented 5.6% of all public finance, of which the subsidies to banks were 3.4%. The burden of moral hazard associated with privatization on the expenditure from public funds was large, though bearable. The main burden emanated from social and economic opportunity costs of bailouts: they limited the finance for more efficient government schemes. Some of the latter were the strategic schemes of **SME development** and **investment incentives** (discussed in the chapter about CzechInvest), as can be seen from Table 5. Having less public funds for more efficient public administration meant that incentives had to be found in implicit subsidies, such as tax breaks and sales of public property at discount prices.

Stabilization of the corporate governance in banking sector led quickly to the elimination the moral hazard of enterprises that gave a clear spur to enterprises with productive orientation. In addition, there was more security offered to them by improving legal system of contract enforcement. The ensuing influx of foreign investors brought the Czech economy on a new path of sustainable growth that became apparent since 2000. It was since the new millennium only when the transformation of the Czech economy was so advanced that the country could embark on the **implementation of new industrial policies**.

These policies were associated with the strategies undertaken by the Ministry of Industry and Trade (MIT), and the Ministry of Education. Some policies were exercised directly by MIT. They targeted mainly domestic manufacturing firms, their innovation programs, information flows about business possibilities and the support of SMEs. However, the decisive responsibilities for the policies of strategic development were conferred upon CzechInvest, the central investment promotion agency.

The success or stabilization policies during the period of 1997-2001 was often disputed by pointing to its low growth, to too restrictive monetary policy and to incorrect targeting of the state aid. The first proviso seems justified: the official figures for growth during 1997-2003 claim the average annual growth of 1,7%. Why did we need such complicated refurbishment of the whole economy when all other transition countries in the region grew at rates two to four times higher even without such schemes? The problem of growth in transition under deep restructuring is indeed a hard methodological topic, as we will illustrate on Figure 7.

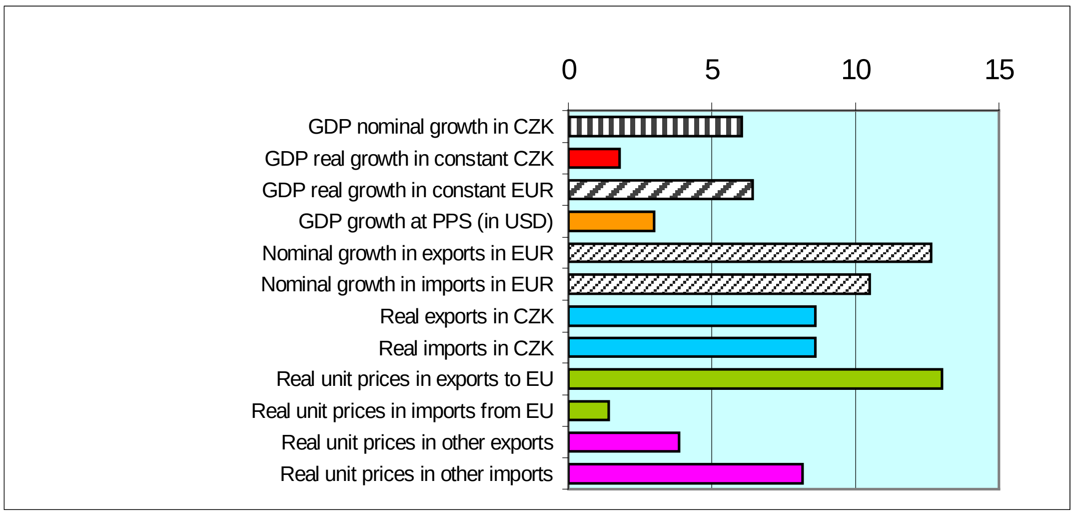


Figure 7: Czech economic growth – alternative views on annual growth rates in percentages for 1997-2003

Source: Czech National Accounts and the Czech Statistical Office Trade Database, 2004.

The problem rests in the difference between the red-marked real growth of mere 1.7 % and the nominal growth of 6,1%. Once the specifics of transition impede the objectivity of the measures of growth, the policymakers lose an important criterion for their feedback. The discussion returns back to our opening chapter where we discussed the bias in overshooting the growth during the period of command economies. We claim that opposite bias occurs when centrally planned system is transformed into market-based economy. At that moment the prices start showing rising utilities of **new or upgraded products because of the innovative customer-oriented restructuring**. Prices rise quite sharply and there is a bias to interpret them as inflation. Thus we lose the feedback reflecting the changes in system's quality. Conventionally estimated deflators can therefore undershoot the real growth based on the concept of utility.

The situation becomes critical in estimating the growth impacts in the export segment. Sharply rising real unit prices of exports, the substitution of stagnating traditional products by trendy innovative products in both exports and domestic consumption, the influence of rising terms of trade or the excess imports over exports – all these point to rising standards of living that contradict the low official figures of growth. Applying deflators derived from domestic prices on exports (i.e. on the value added embodied in exports free of import contents) can seriously impair the statistics of overall growth. Rising terms of trade due to higher export prices have hardly anything common with the decreasing utility per value unit (as is typical for inflation). Both are utility-enhancing changes at the level of a product quality upgrade.

The estimates by Hosek /2004/ confirmed that, by using the methods of command GDP or GDP adjusted to trade balance proposed by Kohli /2003/, the Czech real growth would double. Filer & Hanousek /2000/, and Hanousek & Filer /2004/, estimated that Czech real growth would be actually even higher (up to 5 %) if the bias in the quality upgrading is eliminated and if the deflators are corrected by the influence of three additional factors.

a/ Consumer substitution: due to differences in price changes consumers are more flexible than is estimated by the sampled statistical price surveys in purchasing lower-priced goods. Their weight in statistics is thus underestimated.

b/ Outlet substitution: statistical officers visit with their surveys long-established shops, discriminating thus new outlets (such as hypermarkets or temporary sales) that offer large initial price discounts.

c/ New goods bias: there is a delay when new price-competitive goods enter the market and when they are included in the surveys. E.g. using the system of baskets with constant prices for more than 5 years virtually eliminates such adjustments.

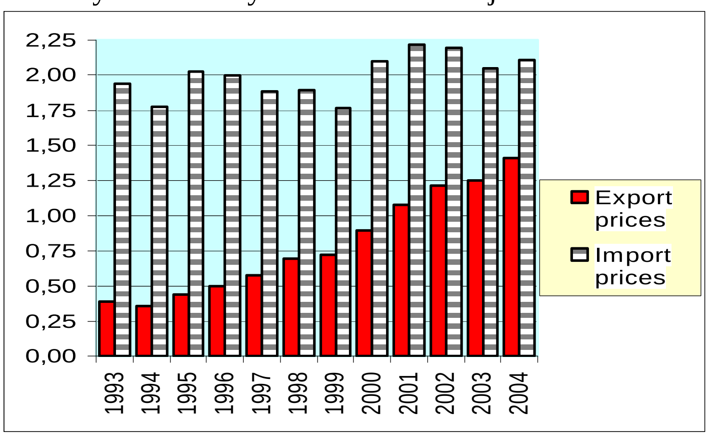


Figure 8: Unit (kilogram) prices of Czech exports and imports with the EU in real EUR
Source: Trade Statistics of the Czech Customs, 2004

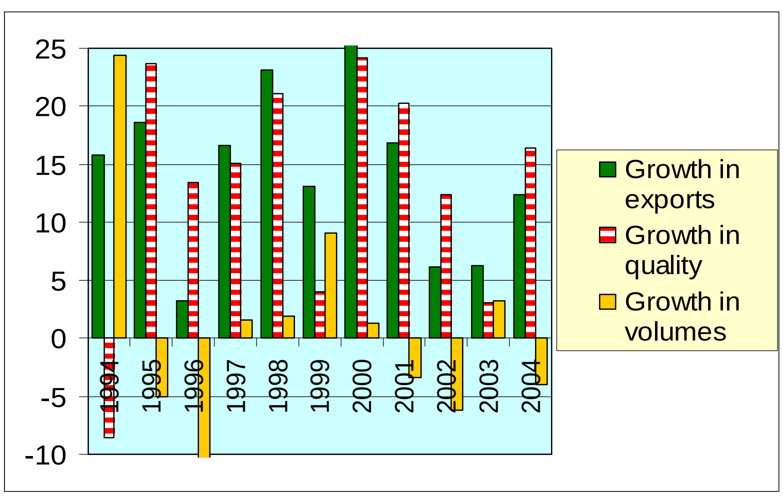


Figure 9: Real growth in exports to the EU due to gains in quality dominating over the growth in volumes.

Source: Trade Statistics of the Czech Customs, 2004

Indeed, it is hard task to admit a poorly performing Czech economy during 1994-2004 once it was able to achieve constantly record-breaking export figures pointing to systematic qualitative break-through in the production of tradables, as the patterns described in Figures 8 and 9 clearly indicate. If nothing else, sharp improvements in **the quality of Czech exports to the EU were undisputed** (see Dulleck et al. /2003/) **and they point to a build-up in competitiveness that was and remained until now among innovative leaders of the post-communist countries**. It would be also very difficult to explain otherwise why during 1994-2004 Czech real exchange rate to euro was appreciating annually by 3,6%, why the real wages rose by rates of 4,6% and why the purchasing power of Czech wages in the EU-15 was strengthening during these 10 years at a rate of 8,8%.

Therefore the proviso about wrong policies targeting wrong beneficiaries during that period is justified only partially. We should distinguish between **discretionary interventions** of the government directly from the public budgets that helped the weak, and policies exercised by CzechInvest that targeted the strongest agents in the competitiveness business. Zemplinerova /2006/, estimated the efficiency of the former on industrial data and found the following:

a/ The annual explicit state aid to enterprises (with agriculture and transportation excluded) comprised approximately 3-4% of the GDP in the period 1998-2002. That was significantly higher than in EU-15 where it was 0.45% in average and none of its countries contributed more than 0,8%.

b/ Industries that received highest subsidies were concentrated mainly in the sectors with either low import competition (such as dairy, meat or flour processing, and production and repairs of locomotives) or where the industry was under demise (traditional machinery and chemistry). There were only minor subsidies to competitive industries where inefficient domestic producers were crowded out by much stronger enterprises under foreign ownership (car components, plastics, electric equipment). Zemplinerova presumes that none of them would deserve such a policy support.

c/ The tests on data confirmed that direct state aid to enterprises was **negatively correlated** with their indices of competitiveness in both the volumes and the rates of growth. The aid was even negatively correlated with the shares of indigenous firms on domestic markets and the shares of imports on total domestic sales in their industry.

Zemplinerova and Panes /2007/ analyzed the subsidies in correlation with changes in competitiveness. Their graph is indicated in Figure 10.

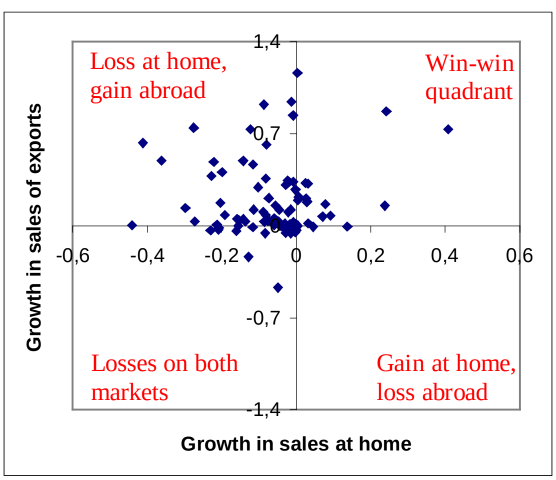


Figure 10: Gains and losses in sales of 89 industries at home and abroad 1998-2002 in the Czech manufacturing (related to total sales).
Source: Zemplinerova and Panes /2007/.

In this graph the index of unity indicates a change equal to 100%. We can see that the vast majority of gains in competitiveness during this period were in export expansion where internal market had to yield to import competition. This is a situation typical for deepening intra-industry specialization. As Zemplinerova and Panes discovered, the state aid was significantly correlated with industries in the lower half of the graph, i.e. with the strategy supporting the weak. It became apparent that subsidies could not reverse the losses in competitiveness, except for slowing down their reallocation to more progressive sectors.

To a sharp contrast with the bailout policies of the Government, the policies of CzechInvest were much less dependent on the government finance. A large part of them were financed from the EU Funds. The targeting on green field investments made these policies correlated with comparative advantages and with commodities showing highest indices of competitiveness (e.g. in export penetration). At the same time it was obvious that Czech growth was driven by exports throughout 1995-2002, meanwhile a large part of non-tradables became the impediment to growth. That means, policies of competitiveness were not in conflict with growth, which cannot be said about the policies supporting the non-traded sector.

To conclude, the policies of the Czech government since 1995 were three-pronged:
a/ In the first tier there were **institutional changes** associated with legal revamping that had strong positive effect on the restructuring and the growth of healthy firms.
b/ The second tier belonged to policies aimed at **stabilizing the disruptions** in the profitability of domestic producers hit restructuring. These policies helped the employment but slowed down the growth.
c/ The third type of policies supported innovation, start-ups, coordination along the supply chain and externalities (e.g. spillovers). The first and the third tier of policies were robust enough to outbalance the burdens of the second tier and keep the economy running at rates compatible with the high growth in the neighboring Visegrad countries.

Digression 4 : Problems with the evaluation of success of the policies of restructuring by relying on the GDP growth

GDP as a final criterion often fails is revealing how successful the policies were when the restructuring of the economy changes fundamentally both its industrial structure and its behavioral (normative, institutional) characteristics. ***GDP is not an indicator whose measurement is neutral to changing institutional arrangements****. Different institutional systems have different demands for products, different techniques of cost measurement, different prices and different interpretation of inflation. In another words, two economies with* ***different social systems and different normative base*** *are not comparable merely on GDP figures or their growth rates. Institutions of transition economies are constantly under a change, the speed of which is by a wide margin higher than in stabilized economies (as we illustrated it on the comparison of the communist and the transient economies in chapter 2.1). Therefore also the measurement of GDP varies in them subject to time.*

Although we know how to rank Pareto superior and Pareto inferior results of simple policies targeting one objective, we have problems with ranking two states of an economy described by vectors, where not all their elements characterizing benefits move in positive direction, violating so the conditions for Pareto optimality. The rough approach by smoothing-out the opposing partial developments in the vector elements can seriously misrepresent the real outcomes.

Such results can become even more ambiguous if there are conflicting outcomes in evaluating them by alternative techniques. For example, how to interpret an improvement in the GDP while the GNP declines? Similarly, we could get to a conflict while using the so-called command GDP and it various adjustments by using terms of trade, current account balance, financial transfers, etc. Is an economy better off if its output has increased sharply but at the same time the economy got indebted abroad and a large part of incomes was transferred abroad?

The outcome of Czech transition and its policies offers some of the weirdest examples of the ambiguities of growth. The papers pointing at the shortcomings of the GDP measurement mentioned above reveal that the problem is more general, even though the standard economies are less prone to be hit by them. Prosperity of countries in the era of globalization is ever more derived by financial transfers, Ponzi games, trade with virtual products and gains from vertically differentiated specialization. However, are such gains sustainable? [17]

First Principles – DON'Ts and DOs in the completion stage of transformation (1998-2002):

1/ Do not carry on with traditional industrial policies that try to produce winners out of losers. This antiquated stage of policy-making is counter productive. Unfortunately, once there are the "skeletons in the cupboard" someone should bounce them out so that the competition for the winners of transition is clear of impediments. Government should lead the way for **securitization of debts**. The subsidies can be large but they must be final once for ever.

2/ In parallel, there should be exercised modern industrial policies supporting the processes, which facilitate the **rise of new business**: the entry of large companies from abroad and the alignment of indigenous firms with them. The positive experiences with Irish strategies of development can inspire the creation of similar policies adjusted to local conditions.

3/ Since the catching up of former laggard economies implies the **widening of industries and products with comparative advantages**, the policies should target their weakest links – those of **emerging non-traditional products and new activities** that develop the potential to spawn into areas of specialization. This is a trial-and-error process where government incentives should be strictly **co-financed by private funds**. The experiences of CzechInvest with FDI attraction or of municipalities with industrial parks shows that ratio around 1:5 (i.e. the public participation around 20%) is a prudent limit for government ventures where the risks of losses are immediately signaled by the private partner and the "sunset clause" can be applied.

4/ The presence of strategic foreign investors should be used by enhancing the potential for **absorption capacity of spillovers** among local businesses. Czech experience shows that productive coexistence of foreign and indigenous businesses cannot do without **high-level political backing** that is able to sell this program to the electorate. The executive part of the program must be vested in an elite agency whose staff is selected on competences and whose performance is monitored regularly. However, its operational agenda can be outsourced to private agencies, delegated to respective municipalities or shared with the targeted private investors.

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[17] *There was an interesting the debate initiated by S. Houseman and M. Mandel (see e.g. Business Week June 18, 2007) about the US "phantom GDP" caused by offshoring (i.e. the apparent overshooting of the GDP growth in USA, which must be compensated by opposite undershooting in countries receiving the contracts). The subprime loans controversy revealed another channel of unsustainable modern growth. As it seems, enigmas of modern growth will not remain topics concerning exclusively the emerging economies.*
We can also presume that the economic contents of the standard GDP measure is bound to "soften" in its descriptive power as the globalized economies will concentrate more on the exchanges of incomparable virtual services. At the end, the GDP will have to be supplemented by a more meaningful indicator of wellbeing.

5/ The **role of municipalities** is unique because they are the direct stakeholders of both successes and failures of investments. Instead of subsidizing the firms directly from central government, the subsidies should be channeled via regional governments that have to treat them as a partial **contribution to be invested into public assets** (such as land or infrastructure) **redeemable in the future**. All partners are then committed towards positive future yields. The ideal financing could look like this:
– full government coverage of the overheads of promotion agency (2%);
– lead grant ("incentive") of the government to municipality, potentially redeemable (13%);
– leveraged loan of the municipality hedged by a collateral (10%);
– guaranteed investment commitment of the targeted private investor (70%);
– commitments of follow-up private investors (5%).
Once the strategic investor guarantees his/her investment commitment, additional incentives can be released: training of employees, tax breaks, credits with low interest, etc.

6/ The sector of banking and **financial intermediation** should be tuned up to internationally competitive standards, so that processes of restructuring do not get stalled by the bottlenecks caused by the shortage or the misallocation of funding. In this context the strategic public funding should be allied with private co-funding.

7/ The government should anticipate the completion of this "pre-maturity" stage and prepare for a **switchover to the policies of "a mature economy"**: to the generation of new skills, knowledge and R&D. Building an efficient system of education and science is a long-lasting process, thus their restructuring should be conceived ahead of time.

Digression 5: Capital Acquisition, Banking and Debt Relief Policies
Please see Appendix 2.

2.5. Policies of the Mature Post-stabilization Period (2003-2012): Targeting Competitiveness Based on Human Capital

In the previous chapters we have described how the Czech economy was changing its institutional framework in four stages in the period of mere 19 years. None of them was sustainable – either in long-run (the communist stage of departure) or in short-run (remaining three transitory stages). This is in contrast with the development in countries under a gradual evolution (e.g. in Canada) where institutional changes of similar extent are spread over a period of more than 60 years.

In this final chapter we will discuss the dilemmas of strategic policy-making aimed at an accelerated reallocation of production to comparative advantages of higher ranks in distinct stages, as it happened recently in the transition economies in Central Europe. As we have seen from the previous chapters, in the Czech case **each of such stages required different policies** for its progress and the **private-public interaction was always in the forefront of changes**. Some of the interaction was manipulated by vested interests and brought the society to risky counter-productive situations in some partial institutional arrangements. At those moments it became apparent that the existence of the third pillar of development was absolutely crucial: the processes of formal and informal democracy had to intervene and divert the society back onto a productive path. Although their feedback loops were rather slow in reacting, the correction took approximately 2-4 years to implement. There was also visible an attenuation of excesses.

Only after reaching the fifth stage of transition Czechs could start thinking about local policies that would be on par with developed countries with a long history of market performance (e.g. Switzerland). The EU accession and competition with other transition countries that required stabilization and **adjustments to exogenously given benchmarks** was an important part of that process in Central/East Europe. We can therefore expect there will be soon several countries from this part of Europe that would be ready to join the club of advanced economies – i.e. economies where the objectives of competitiveness via high-tech innovation have been in the core of policy-making. The club of such high-performing latecomers includes Ireland, Estonia, South Korea, Taiwan or Malaysia that followed its predecessors from 1950's, such as Japan or Austria.

At this moment we should remind that transition economies share many features with more advanced developing countries, for which the attribute of *emerging or catching-up economies* is used most often. Such common features include: the rescue from the trade barriers (most often of the non-tariff nature); break-through in access to financial capital; deeply undervalued exchange rate; low wages; overcoming of the specialization in trade that offers neither high growth nor improving terms of trade; widening gap between rich and poor; deficit of democracy; informality and cronyism suppressing the rule of law; and market signals that bring short-run decision-making in conflict with long-run goals. The latter can be taken for a natural deficiency of markets – the strategic policies of the government should therefore overarch such discrepancy and stimulate markets to smoothing-out its scopes of vision.

The graph below is explaining the dilemmas between short-tem and long-term decision-making that pose the crucial conflict in the progress of development in transition/emerging economies. Potentially their growth can be very fast, provided these countries are able to adjust their economies to changing environment in two decisive fields:

a/ to rapidly changing comparative advantages defined on factor endowments in the traded sector;

b/ to sustain the productive contestability in the non-traded sector, which should avoid becoming a refuge of the rent-seeking entrepreneurs.

Both of these factors present a threat of an institutional lock-in that paralyzes the required re-adjustments in the socio-economic organization of fast growing emerging economies. Their trade-off is between costs and benefits in the short-run versus in the long-run visions. On the one hand there are the benefits of avoiding sunk costs by sacrificing the changeover to potentially more profitable allocations. On the other hand there is the maximization of future incomes by sacrificing the short-run gains emanating from existing allocations according to given comparative advantages.

Let us consider the transition from an economic slackness caused by institutional rigidity (in this case represented by the communist system), which has to get through two unavoidable interim stages that are dominated by the evolving factor endowments. In the first stage of transition T the economy plunges into the comparative advantage given by simple labor endowments. Exports of labor-intensive commodities accelerate because they are most profitable. The reallocations cannot but react to that, even though these new capacities are bound to lose soon its competitive edge as the endowments of capital are accumulating, supported also by pro-investment policies. In the Czech case this took approximately 6 years. If the policies do not respond ahead of time, the perseverance in labor-intensive production (L) would bring the economy to a secular stagnation below the orange-marked minimal catching-up rate of 4%, as is shown in Figure 11. Point A marks the inception of new policies building-up the capital-intensive production K (such as machinery or chemistry), even though at the given moment their growth perspectives need not look high.

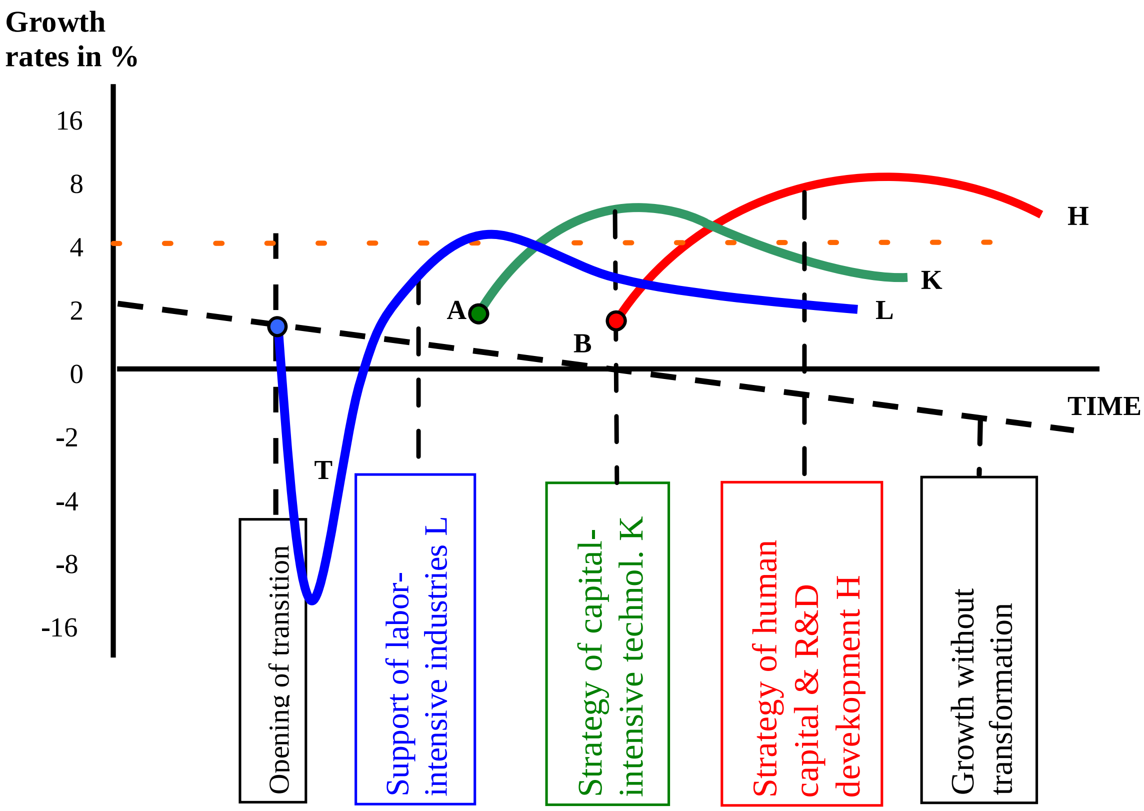

Figure 11: Policy dilemmas: transition based on comparative advantages – static versus dynamic interpretation of policies.

A more dramatic situation arises, however, when the policies commence furthering the knowledge-based economy where the development of human capital should have a lead of at least a generation. Industrial policies supporting high technologies (H) in point B should start already in times when such investments would not be undertaken by the private sector because they are much less profitable than current "standard" technologies. A lot of criticism can be heard at that stage while the lobbies cry for policies supporting the successful industries of their own. In the Czech case the restructuring policies of the K and H production type were borne by CzechInvest and the break-even point (B) occurred in 2000.

Restructuring (industrial) policies are important, indeed, even though they cannot revitalize economies out of the context of their real development by means of a policy boot-strap lifting. The stages of growth cannot be skipped. For example, a poor economy driven by labor endowments cannot aspire to leapfrog directly into a knowledge economy without having built sufficient capital base for financing education, science and progress in medium technologies. Figure 12 describes the evolution of industrial policies supporting the buildup IC technologies based on human capital endowments.

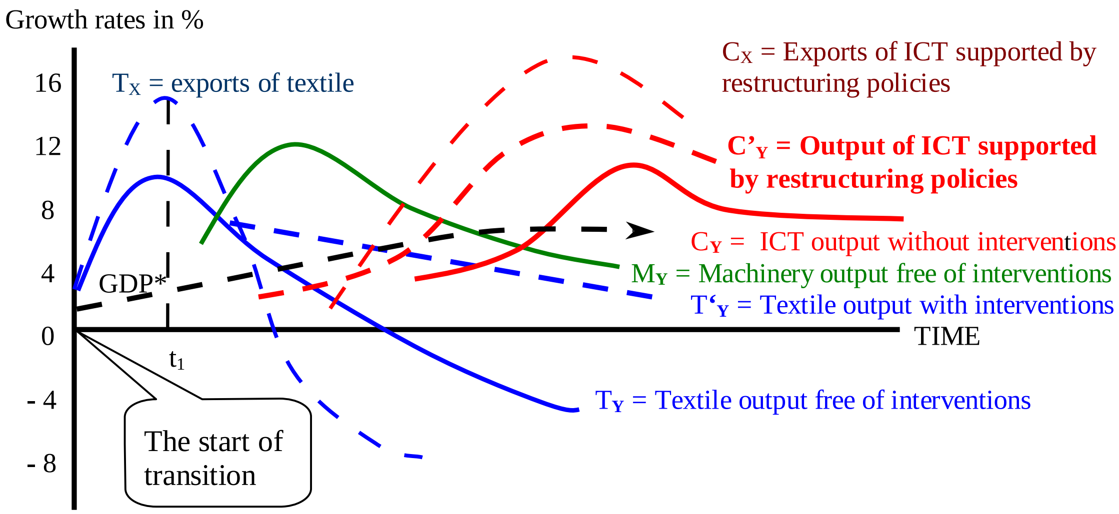

Figure 12: Three stages in the industrial (restructuring) policies – textiles, machinery and ICT

This figure illustrates Czech experience with policies that have to respect natural development by supporting industries characteristic of the given stage of development. Without such promotional policies and incentives the targeted long-term growth of 6% could not be achieved. In the early stage the labor-intensive (textile) industries have got the highest growth. Unfortunately soon (in time t_1) it will be apparent that they will have to be soon dislodged by rising import penetration and the surge of capital-intensive technologies (machinery). The fact that such qualitative structural changes in small economies are export driven is depicted by dotted lines. Thus exports serve as leading indicators of natural restructuring. However, since high technologies (represented here by ICT) require an undergoing change in factor requirements proceeding long before the expected ICT growth, it is the government policies that should anticipate such changes and stimulate their development in the private sector. The policies should be initiated already when the medium manufacturing technologies are at their best.

Restructuring policies have their risks. First, the government can target emerging industries that will fail in becoming winners. Not all high-tech policies will be matched by fault-free innovative entrepreneurship. Therefore instead of industries the policies should support more universal factors behind their growth (e.g. R&D, education or infrastructure). Second, lobbies can demand that policies are targeted either at already well performing industries or at present losers that have been "under an assault by unfair foreign competition". The latter protectionist policies will miss the long-term target. Only the forward-looking policies where the government acts as an entrepreneur, anticipating future events by investing in their support, will drive the long-run growth rate up. There are three advantages that emerging economies have in contrast to the advanced economies on the frontier of development:

- They risk much less in enlarging their production possibility areas because they can imitate the already known technologies.
- They can replicate creatively the institutional architecture that helps promote the organization of more productive societies.
- They can join the globalized network of markets and enlarge their scope by offering for exchange commodities complementary to those, which the advanced economies specialize in. That means, instead of crowding-out the existent specialization pattern, they extend its frontiers. Their participation in inter-industry division of labor (e.g.

textiles or cars for ICT) and in vertically integrated intra-industry specialization, the trade creation dominates over the trade diversion.

Figure 13 illustrates the aforementioned characteristics in restructuring of the traded sector on the data of Czech manufacturing exports and output (according to Zemplinerova /2004/)[18].

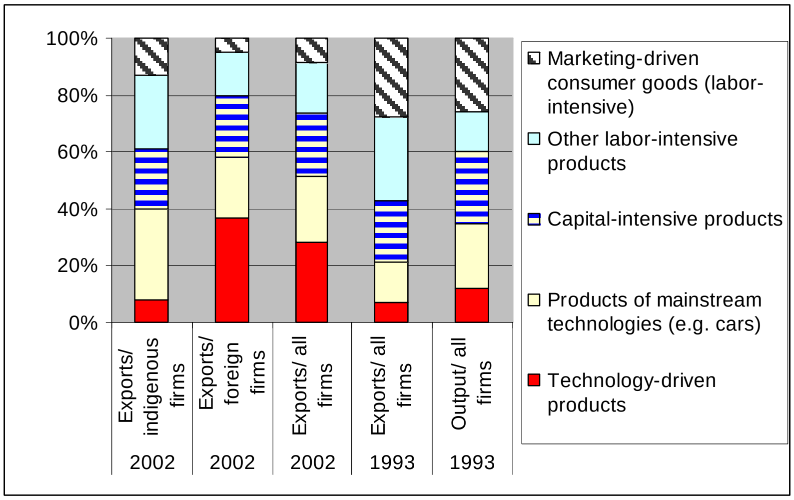

Figure 13: The evolution of qualitative characteristics of Czech exports in manufacturing based on technologies (1993-2002).

Source: own computations based on data used by Zemplinerova /2004/.

Remark: please notice that the shrinking structure of a sector does not imply that its industries also had to shrink because the GDP has increased by 30% during 1993-2002 and its equivalent in constant euros of 2003 increased by 131%.

The changing structure of Czech specialization is most visible by looking on the groups of industries divided by ownership in 2002. Meanwhile the indigenous producers were abandoning the past patterns rather slowly, their main accelerated drive was towards the mainstream (medium) technologies. On the other hand, enterprises with foreign capital based their growth mainly on exports based on high technologies. Their position in mainstream and capital-intensive technologies was also strong. There was a common retreat from exports of labor-intensive products that became crowded out by imports. Industrial policies were an important factor in the restructuring of Czech economy throughout all transition period.

We shall concentrate in Part II on the policies for attracting FDI, cooperation in the supply chain, absorption of spillovers from foreign to indigenous firms, reduction of unemployment and the support of entrepreneurship, as they were exercised by CzechInvest. In Part III we shall discuss first the policies of the Czech Ministry of Education, the objective of which were the qualitative upgrading of education, buildup of human capital and the support of science in order to boost the competitiveness of enterprises. Subsequently we will look at the policies of the Ministry of Industry and Trade that also include the policies delegated to its special agencies and organizations supported from public funds.

[18] Thanks are due to Alena Zemplinerova for the permission to use her data for the estimates in this table.

First principles of the mature post-transformation period (2003-2012)

a/ Transition, emerging and/or catching-up countries cannot skip the interim preparatory stages of their development that tune up their economies for the break-through in launching the policies of innovation and knowledge.

b/ Preceding macroeconomic stabilization must be accompanied by a profound revamping of the socio-economic institutional setup – i.e. the mechanisms of adjustments between economic agents. There should be available public space for free communication between businesses, public administration and citizens. Their progress should be screened by feedback mechanisms aligned with political instruments for making mutual concessions and for reverting actions leading to blind alleys.

c/ The transformation of the public administration should be in the core of institutional revamping. The government should adopt the managerial techniques of the large entrepreneurial sector (e.g. that of transnational corporations) because the pending tasks are of entrepreneurial nature where innovations, rational expectations, anticipatory actions and risks are a part of decision-making.

d/ In contrast to traditional politics concentrated on medium-term aims and redistributional policies, the government should follow long-term visions transcending their electoral mandate, where the strategic objectives are underpinned by consistent means, i.e. by policies consistent with targeted changes in factor endowments and the behavior of economic agents.

e/ All stakeholders should be aware that expected changes in comparative advantages of the country are not costless. Therefore the policies promoting new technologies and new market entrants should be combined with policies targeted at the losers of that process. Instead of protracting the agony of their survival, the restructuring rescue policies should target the functioning of instruments that will cut transaction costs and speed up the voluntary reallocation of factors. Nevertheless, the existence of social safety net for relieves of losses from restructuring cannot be avoided.

f/ The paramount aspect of all policies promoting investments should be again the removal of transaction costs so that it will be the markets that will help optimize the effects of relocations.

g/ All policies should be subject to clear criteria and benchmarks for the monitoring of their progress and failure.

h/ The transparency of policies should be indisputable so that political opposition, media and general public can freely asses their aims, costs and benefits. Their objections should be a part of political dialog in search of public consensus building.

i/ The strategic policy-making and its operational execution should be subject to specialization. The latter should be delegated either to specialized authorities subordinated to the government (ministries) or to agencies with partial autonomy and demonstrated competence subject to accreditation for certain tasks and objectives.

3. National Plans as Indicative Targets for the Administration of Public Governance

The combination of three factors associated with advanced countries exposed to globalization:
a/ widely open tradable, financial and labor sectors subject to market imperfections;
b/ rising importance of public administration at European, national and regional levels in the responsibilities for the efficient provision of public goods;
c/ initiatives of the civil society in the sphere of social governance;
implies that various socio-political hierarchies and pressure groups intervene with the functioning of markets. The management of such hierarchies and interactions of involved social organizations requires a system of coordination, which should be guided by human values, ethics, political priorities and markets. There is no other alternative than to coordinate the actors by "plans" that harmonize the interrelated strategic, tactical and operational moves between all kinds of stakeholders of such a multi-faceted social governance.

See Figure 14 with Engel curves depicting the diminishing rates of growth in the traditional sectors (i.e. those closer to the bottom, such as agriculture or manufacturing) as the fast developing "new" goods crowd them out. The result is a declining share of "traditional goods" on the GDP, with the exception of public goods that became in the last 50 years the fastest growing segment of developed economies. Public goods are also closely related with the human capital, ICT, high technologies, medicine or infrastructure that are key factors of the competitiveness in economies without rich natural resources. Governments of advanced economies are traditionally involved in their supervision.

Of course, the government supervision of public goods does not imply that they should be also exclusively produced by the public sector. This feature rests behind the rising importance of the public-private cooperation / partnership. The political battle concerns the question which goods are the true "public goods". In reality all goods are actually mixed goods where private and public aspects of their existence are intermingled, even though at highly differentiated degrees. Thus the issue is whether the "true" fuzzy division line is not lying somewhere in the space depicted by the intermittent thin blue curve in Figure 14.

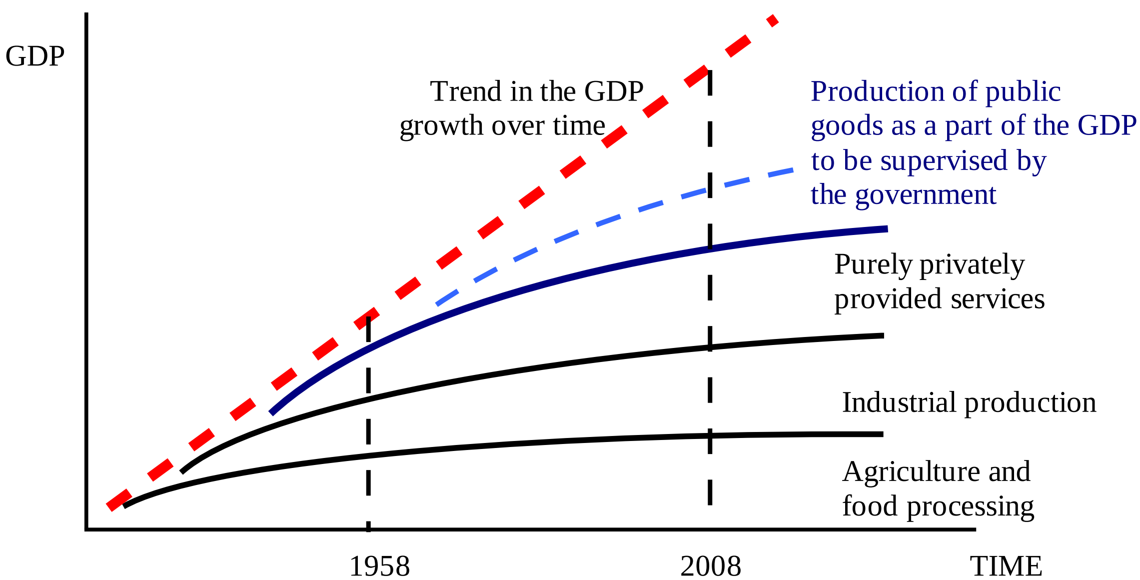

Figure 14: The rising share of public goods on the GDP

The confusion of this kind of indicative plans with communist central planning is flawed, even though central planning could not ignore the importance of coordination of social agents. Firstly, central planning lacked functioning markets and the majority of its interventions was an inferior substitution of missing information. Secondly, central planning was not a democratic process of nation-wide negotiations. It was a dictatorship of the privileged ones, instead of a devolution by surrendering autocratic powers to lower-ranking social representatives.

Therefore one should not over-estimate the importance of these plans, even in such a traditional planning-dependent country like Czechia. For example, in the post-communist Czechia there have been constant problems in transforming strategic documents ("Plans") of one government into policies of a new government in the political cycle. There have been even problems in coordinating the work of ministries if they were run by different parties of the coalition. The policies of CzechInvest (2000-2006) were some of the rare strategic activities that were prone to inter-ministerial controversies.

Already during 1948-1989 the system of central planning was not a dogma, especially after the waves of relaxation from Stalinism in 1956 and 1963, even though Czechoslovakia together with Eastern Germany still retained one of the most rigid planning systems among communist countries. It was the enterprises that masterminded the planning process since early 60s until its demise in 1990. It was a sort of state capture offering advantages neither for the consumers nor for the competitiveness of enterprises. We have discussed its pros and cons in chapter 2.1. (p. 10) of Part I.

Therefore, as a recoil effect characteristic for post-communism, any attempt at setting quantitative goals or commands for resource allocation from the state authorities in this country are opposed by all entrepreneurially minded people. During 1990-97 Czechia had a conservative government, whose leader (V. Klaus) was against any sort of central intervention into the economy. There were only macroeconomic targets (balanced budget, stable exchange rate and stable monetary policy under inflationary targets converging from 10% in 1992 to 5% in 1998). There was also the Privatization Strategy for 1991-97 – all perfectly in harmony with Washington Consensus of the World Bank (see the end of chapter 2.2. above). Only after 1998 it was apparent that **the government sector (i.e. public administration, education, R&D, police, transport, healthcare, defense)** will need some guidelines for policies and spending that would be longer than **One Year Government Spending Plans.**

Czech strategic plans are **strictly indicative** and they address the policies and spending in the public sector, including the interface with the private sector (such as R&D, pension contributions, FDI incentives). A large part of such plans responds to the EU/EC policies (e.g. Lisbon Strategy – Education and R&D, or European Funds dealing with Structural, Cohesion and Agricultural policies).

Czech Long-range Strategic Planning Institutions and Instruments in a Nutshell

This crucial mechanism of social governance can be described as the evolution of the interference between public administration and private sector with the accelerated metamorphosis of the whole Czech society after 1989.

After the fall of conservative government in 1997 it became clear that the new government must set an indicative document of long-term VISIONS (without any quantitative targets of structural limits that would have an impact on the **private** sector), which should be called officially a **STRATEGY** or a PLAN. The first real plans originated al late as in 2004, in the year of Czech EU accession. There was launched the 2004 **National Development Plan I (NDP)** that coordinated the areas of support from European Funds with national spending and policies on R&D. It influenced a <u>very narrow</u> part of the real economy.

Nevertheless, it has and important impact on the design of the **National Innovation Strategy** of 2004 and the **National Innovation Policy for 2005-2010**.

In parallel with the NDP there was proposed in 2004 **The Strategy of Sustainable Development**, which was influenced by the World Summits in Rio and Johannesburg. It was a product of the **Government Taskforce of Experts**. This extensive document proposed to a national debate. There was quite a critical feedback and, at the end, its real impact on the economy (i.e. the behavior of agents) was practically negligible.

In 2005 the government launched the first global economic document: **The Economic Growth Strategy (EGS).** Even though it was a plan copying the EU (Scandinavian or Austrian) growth strategies, politicians interpreted it as a document of Social Democrats and as a challenge to Conservatives (ODS) prior to elections in 2006. EGS was prepared by the Vice PM Jahn and all plans of CzechInvest were derived from it (see p. 87 of my Part II). Similarly it influenced the **New Export Strategy of the MIT** (for 2006-2010) and the **Innovation Policy** (proposed by Research and Development Council with the help of the Ministry of Education and MIT).

Actually the initial move to set the long-term Economic Growth Strategy came from the **Tripartite** (The Council for Economic and Social Accord) already in 2004. It had a cross-party aspiration and it avoided the use of policies that might lead to left-right controversies (e.g. taxation rates, university fees, payments for healthcare or types of pension system). The EGS has not been repealed officially even after the changes in the government in 2006 and 2007 (socialists out, conservatives in). However, its importance on new policies (flat tax, healthcare private co-financing, privatization of hospitals and downsizing of CzechInvest) was minimal. The new government has resigned on long-term visions and its policies are more *ad hoc.*

The topical underpinning of strategic plans can be illustrated on the framework used for the design of EGS. The agenda had a form of a matrix where reform areas were listed in rows: Human resources; Financing; Legislation; Environment of organizations (private, public, NGO); Means of coordination and cooperation (see Figure 15). In colums there were objectives aiming at improving the linkages in columns to R&D innovation creation; R&D innovation transfers; Entrepreneurship R&D implementation. Each of the 15 cells of the matrix had a special working document that concentrated on the reforms in given area.

A similar approach is used in many transition countries. Its best description can be found in UN ECE /2007/.

	R&D / innovation **creation**	R&D / innovation **transfers**	Entrepreneurship – R&D **implementation**
Human resources	. . .	. . .	. . .
Financing	. . .	. . .	. . .
Legislation	. . .	. . .	. . .
Organization/environment	. . .	. . .	. . .
Coordination, cooperation	. . .	. . .	. . .

Figure 15: Matrix of barriers to competitiveness as used in the Economic Growth Strategy /2006/.

Czech National Development Plan and National Strategic Reference Framework

The **National Strategic Reference Framework (NSRF)** for 2007 - 2013 was drafted as a reference document for negotiating the development policies with the European Commission. It followed the indicative visions outlined in The **National Development Plan II** (2007 - 2013). Both documents are based on respecting the **principle of partnership**. In the Czech case the partnership stresses three pillars of development: the cooperation between governments (central and regional), businesses (now practically all private) and the civic society (e.g. NGOs and other civil initiatives).

In 2006 the European Commission laid down new general provisions for common European policies: on the European Regional Development Fund, the European Social Fund and the Cohesion Fund, which guide the EU policies for 2007-13. Thus all 27 members of the EU were supposed to follow similar guidelines coordinating national and communitarian socio-economic strategies.

Although coming as an external spinoff, the **policies of partnership** are a part of the Czech culture since the times of National Revival (a sort of cultural and nationalistic follow-up of the locally belated industrial revolution and democratization of the 19th century). Thus Czechs are used to a system, in which power is shared out between social groups (or their representations) at various levels of the society (e.g. income hierarchy) [19]. **Such a system needs a lot of negotiations, compromises and compensations.** Thus its negative externalities leading to rivalry, corruption, anti-elitism and the general discontent [20] are its most visible liabilities – notwithstanding that this system is constantly demanded because it offers that everybody can, at the end, get a bit of his/her demands satisfied. The other country that is culturally closest to this type of social governance is Austria [21], a country Czechs shared during 1620-1918.

The Czech **Ministry for Regional Development** (MRD) is in charge of the overall co-ordination between the EU and the national development plans. It was also the driver behind the preparation of the **National Development Plan** (NDP) and the NSRF. As an illustration, an ambition for a very similar power game was exercised by CzechInvest after 2000, especially during 2004-2006 when it could rely on its former CEO Mr. Jahn who became the Vice-PM for economic affairs. Unfortunately (and quite characteristically), the technically and intellectually more elite CzechInvest lost that battle. Thus we should not be surprised by the inflation of parallel strategic documents produced in the last 8 years.

The attention to a **procedural partnership** (i.e. to processes of mutually balanced decision-making, even among political adversaries, in contrast to autocratic guidelines dictated by locally so much hated central planning) is in the foreground of Czech policies of development after 1989. With the EU entry it also guides the coordination between the national and the EU structural and cohesion policies.

The NDP and NSRF were prepared by the **Management and Co-ordination Committee** (MCC) that was set up by MRD. This committee became the most important instrument of the co-ordination through which all relevant public stakeholders were involved in the preparation of strategies for the implementation of the EU SF and CF. The Minister for Regional Development chairs the Committee, other members include representatives of relevant ministries, territorial self-government (represented by regions, City of Prague and representatives of the Union of Towns and Municipalities), economic and social partners,

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[19] This explains why it was so easy to abuse that social arrangement by the communists since 1945.

[20] Czech (as do the Austrians) are always complaining about the public policies, though (paradoxically) it does not mean their refusal of such policies.

[21] The most easily available description of the Austrian system is in The Economist, November 24, 2007, "The Sound of Success: a Special Report on Austria", pp. 1-14.

educational institutions and the non-profit sector. The meetings of the MCC were regularly attended by representatives of the Union of Czech and Moravian Production Co-operatives, the Agrarian Chamber of the CR and the Academy of Sciences of the CR as observers.

Particular institutions nominated their representatives at a high enough level so that the MCC was able to adopt important decisions. Between May 2005 and April 2007 the MCC met nine times. Nominated representatives of partner organizations were actively involved in the preparation of strategic documents for the 2007 - 2013 programming period, mainly by commenting on the submitted versions of strategic and programming documents. The comments were presented at the meetings of the working groups. The comments were then incorporated into the relevant documents, subject to the final approval of the MCC.

The partners also took part in the final commenting procedure. One of their main comments was the requirement for the representation of social partners in newly created management and co-ordination bodies for the economic and social cohesion policy, since such approach has proved to be of benefit in the past period. The partners are supposed to participate in the Monitoring committees and Working groups of MCC dealing with solution of individual questions of implementation. The partners also proposed a requirement for a better interconnection of document analysis, policy instruments and NDP strategies. Other comments concerned formal or formulation aspects (complementation of SWOT analysis, utilisation of up-dated data, better formulation of objectives). All comments were accepted and incorporated in the document. Further discussion with managing authorities was recommended for all comments going beyond the scope of the NSRF and concerning operational programs in a more specific way.

Co-operation with non-governmental non-profit organizations proved very satisfactory. Some parts of both strategic documents were designed (not only reviewed) under the supervision of NGOs. The overhauling of the drafts of NDP and NSRF 2007 - 2013 was significantly influenced by the non-profit sector. For example, the project of Technical Assistance and information campaign were carried out by the Centre for Community Work, a union of NGOs. Projects of NDP and NSRF also included workshops, round tables, seminars and working meetings of stakeholders carried out in individual regions of the CR.

A public debate on the NDP 2007 - 2013 took place in January 2006. A similar public debate on the NSRF took place in November 2006. These documents are available on the website of the Structural Funds and the Cohesion Fund or on other websites of partner organizations.

The selection criteria for projects will also be based on the consultations with economic and social partners. There are seminars and trainings organized for applicants with partners, operational programs are introduced with the help of the partners to the general public and information is also published on web portals of NGOs. The list of government partners include representatives of NGOs, the Chamber of Commerce, the Czech Statistical Office, the Agrarian Chamber, the Union of Towns and Municipalities, the Union of Co-operatives, the Confederation of Industry and Transport, the Chamber of Trade Unions, the Confederation of Employers' and Entrepreneurs' Associations, universities, the Government Council for NGOs, the Government Council for Research and Development, the Government Council for Human Resource Development.

Since 1989 Czechia went through several waves of political, economic and social changes that were not always compatible with each other. They reflected an enormous capacity to re-adjustments reacting to changing nature of the society and to the opening-up to global environment. The active involvement of the country in the EU since its full membership in 2004 has not attenuated such a drive to restructuring. A similar trend is apparent in other new EU members. Thus their convergence towards the more advanced countries of the world is universally recognized. E.g. in 2005 the World Bank upgraded the status of Czechia from a developing to that of a developed country.

In spite of such a fundamental progress in growth and adjustments, Czech economy must face newly arising problems. There are threats to competitiveness (such as appreciating exchage rate, rising wages, shortage of labor, lack of human capital, replacement of FDI by indigenous investments, etc.), social cohesion, sustainability of public finance and governance without corruption or bureaucracy. The solution of these problems is definitely a long-run battle that would require programs in the quality of long-range strategies that would over-arch the terms of governments. The need for cooperation between the public and the private sectors has evidently survived the period of transition, notwithstanding the existence or non-existence of European Funds. The importance of public finance has not declined with the progress of transition to market economy. Private sector opened to international competition is now viable and self-sustainable. The bottleneck in growth rests with the non-tradable sector where public services are clearly its least efficient part. The re-adjustments of public services to efficiency cannot rely so much on the market forces as the tradable sector. The importance of reforms guided by long-term strategies (plans) seems to be a key such further progress.

Czech economy in 2008 has endured the storms of the financial crisis that was initiated in 2007 by the US subprime mortgage wave of bankruptcies. There were two reasons for that: firstly, the Czech economy has experienced its own crisis of subprime loans during 1996-1999, which only two local banks out of 28 survived unscathed. The others were either liquidated or bailed out by the government and sold to foreign strategic investors. The restructured banks were extremely cautious and avoided the previous strategy of investing into financial instruments subject to debt breaching. The second reason was that revived Czech economy after 1999 needed enormous investments and many incoming foreign investors simply purchased their ventures by loans from the Czech banks. The banks had then a wide portfolio of credit lines with first-class investors into productive assets with high yields.

Let us look at the standing of the Czech economy in the ranking of competitiveness prepared by IMD Lausanne and World Economic Forum. The former assigned the Czech economy the 28th rung out of 55 most competitive economies of the world in 2008. (For comparison, Perú as the best performing economy in Latin America ranked 35 and Mexico 50.) The Competitiveness Indes of the World Economic Forum ranked Czech economy at 33rd place, out of 134 analysed countries. (For comparison, Chile ranked 28th, Mexico 60th and Guatemala 84th.) Approximately a similar position in the world ranking of the Czech economy can be found in the Economic Freedom Index for 2008: Czechia scored the 37th rung out of 157 studied countries (Uruguay ranked 40, Mexico 44 and Guatemala 78).

4. Social Partnership Principles in the Czech Socio-economic Governance

There were two sources of guiding mechanisms for social governance guided by plans of action in this country: internal and external coming from the European Commission. The former was associated first (1991-98) with the policies of macroeconomic stability and privatization (following the Washington Consensus). Policies of MIT and CzechInvest that targeted the promotion of FDI and technology transfers (1996-2000) acquired a locally-based features of strategic planning. Later, in the pre-EU accession period (1998-2003), there were attempts at outlining some partial long-term strategies for coming to terms with the annual audits (country reports) of the European Commission that conditioned the EU entry. Thus internal initiatives transformed gradually (after 1999) into activities triggered by the requirements passed on the EU members from Brussels. The domestic autonomy in development policies was gradually weakening. Thus the accession policies dealt with the adoption of the EU legislation (schedules for the adoption of Acquis Communautaire), absorption of EU funds and with questions of nominal and real convergence.

R&D and innovation requirements (partially a spinoff of EU Lisbon Strategy) were outlined already in 2000 by adopting **The National Research and Development Policy**. It is a list of priorities, tasks and financial requirements that integrate the R&D agendas of European Funds, Ministry of Education and MIT. It became a useful instrument for implementing the policies of competitiveness.

In 2002 there was a first attempt of the Czech government at defining a mutually balanced indicative long-range plan called The Strategy of Sustainable Development that covered economy, environment and social equity. With the EU accession all strategic policies are now coordinated with the European Commission.

Let us return back to the principles of socio-economic governance depicted in Figure 1 (see chapter 2.2 and p. 11), where the openness to globalized world implies a permanent re-adjustment to the changes of relative positions between internal and external forces of development. New windows of opportunities and new costs of exchanges between agents call for a smooth reallocation of activities, the gains of which fall asymmetrically on agents. The natural outcome is that politics become an extremely sensitive center of social interaction. No surprise that the role of governments and political parties in modern societies gained significantly on importance. In contrast to communist or totalitarian organization of society, the modern system is more open to democratic principles vis-à-vis the citizens, as is shown in Figure 16. Also the relationship between state and businesses reveal similar trends: it depends now more on partnership and cooperation.

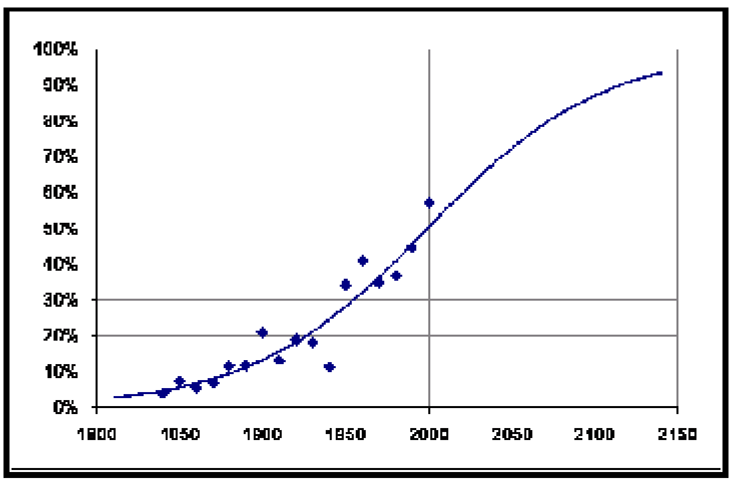

Figure 16: Democratization trends in the world where the share of people living in pluralistic and parliamentary governance system is steadily rising.
Source: Modelski and Gardner, 2002

The concept of alliances and mutual countervailing powers of modern (i.e. open) societies arises due to **objective processes –** that means due to processes exogenous to any grouping of agents. Thus it goes beyond lobbying and political electoral platforms of specific parties. The causes for creating alliances rise above partisan politics – they would be present notwithstanding any political arrangement. Politics and alliances can, however, either speed-up the re-adjustments or they try to impede them. In this study we have shown on the case of Czech society how both forces act in parallel, whose final outcome depends on the policies that alleviate the restructuring, build the consensus and enhance cooperation that lead to economic and social prosperity.

Hence there arises a paramount objective to balance the political claims of agents by means of **democratic auctioning**. There the bilateral relationship between the private and the public sectors have to be open to social accountability. The balance between agents is negotiated at the level of organized public polity – i.e. via political parties, social pressure groups and voices of the civil society. Although the main body of decision-making processes is made at the level of interacting enterprises and institutions of public governance, the final checks and balances remain on the democratic mechanisms.

Czech economic policies had to overcome several turning points, which had far-reaching impacts on the whole society. There were turning points about the transition from totalitarian economics into market-based auctioning, about changing state monopolies into competing private businesses and about transition from the shortage of capital combined with the glut of unemployed to the excess of financial capital and the shortage of human capital. Part II of this study describes how CzechInvest evolved into a public service organization that had to break the ice for opening-up to international capital because the initial policies of transition (like in the majority of countries of former Soviet empire) were marked by excessive reliance on national capital, national entrepreneurs and national markets. Though such policies were natural in their evolution, they were in conflict with the economic globalization and economic growth led by massive gains that emanated from the traded sectors.

Internationalization of the Czech economy that accelerated after 1997, marked an important break-even point in the policies of public-private partnership. It was only after revamping of economic institutions in 1997 and 2004, which allowed for massive inflows of foreign capital and entrepreneurship and that **made the public sector able to become an equal partner to multinational businesses and institutions of Economic Commission**. Additional economic gains from such a partnership had to be shared with MNCs, which required new skills and new organization of public agencies. This process took some time to develop and it was not without errors. However, learning by doing brought its fruits quite soon.

One of the lessons that calibrated the new FDI policies was that subsidized activities must have clear potential for spillovers and demonstration effects, and its incentives should be provided only to (locally) new activities, diversifying the economy. The buildup of agencies specialized in industrial policies required to apply new techniques for both the recruitment of human resources and the communication with all kinds of customers. For example, the crucial point in the performance of CzechInvest was the combination of its alignment to the global strategies of MIT with its managerial independence in other strategic matters. Thus the minister of MIT has the right to nominate and recall the CEO of CzechInvest, but remaining organization of CzechInvest is completely autonomous.

Similarly, MIT nominates the Steering Committee of CzechInvest, but its powers cannot go beyond being an advisory board only. Its main mission is to enhance the flow of information and coordination across ministries and other important FDI stakeholders. Thus MIT has in it two members, as do CzechInvest, Ministry of Regional Development, Ministry of Labor and Social Affairs, and AFI (Association for Foreign Investment). Other partners have one member: Foreign Ministry, Ministry of Finance, Chamber of Commerce, Confederation of Industry, Association of Entrepreneurs, Union of SME, Union of Cooperatives and Guarantee & Development Bank. Multi-channeled financing of CzechInvest from public, private and communitarian (EU) sources makes it to a large extent independent from fluctuations in the fiscal sector. The communication between foreign investors, their domestic private partners, government and general public was achieved by establishing AFI, even though exactly this type of interface organization is supposed to be in conflict with the traditional organization of the public sector that is supposed to be at arm's length with private firms.

Enlargement of the private-public partnership into the **Tripartite** is another crucial institution of modern social governance. In the Czech case its importance increased in parallel with expanding international openness after 1997. The official title of Czech Tripartite is "Council for Economic and Social Accord". It is an advisory board of the government whose members are: the Prime Minister (chair) and six ministers of the central government. Then there are seven representatives of businesses (e.g. their chambers and unions) and seven representatives of trade unions. Tripartite meets six times a year and their agenda is most varied. We can mention among its most discussed topics questions about taxes, social safety net, employment, industrial parks, EU funds, attraction of investors, strikes as industrial actions and the institutions of PPP (public-private partnership). In no case the negotiations of Tripartite can be described as a consensual harmony. All partners fight there for their partial interests. The concluding agenda that is published for the public has three parts:

a/ Common agreements about the agenda discussed;

b/ Recommendations for changes from one of the parties;

c/ Disagreements (sometimes even protests) about the policies.

Although Tripartite has no mechanism that would made its outcomes (strategies) binding, it constitutes an important mechanism for reaching politically viable decisions. It also lessens the tensions by offering its partners the scope for further negotiations. Let us mention that such negotiations can proceed in the chambers of Parliament, in negotiations between political parties, in media and in actions of NGOs.

Another institution that aligns the interests of private enterprises with the aims of citizens and with the objectives of the government (such as building a society of innovation and knowledge) is the creation of development agencies. Here let us mention the examples of Ireland or Finland, where their organizations of industrial policies became the engines of prosperity and economic competitiveness. In the Czech case there was the rise of CzechInvest, as an instrument of openness to the globalized world, that mediated the interaction between foreign investors, domestic enterprises, municipalities and employees. We should stress that such policies must go beyond the mere promotion of new businesses (especially those of MNCs). Thus the policies of CzechInvest had to be complemented with the trade promotion via CzechTrade agency, promotion of education, support of SMEs and social relief schemes for agents stricken by relocation. Parts II through IV of this study concentrate more closely on such aspects of government activities.

Even though Czech experience offers a clear empirical proof confirming that central planning was in a **fundamental conflict** with long-term economic development because it could not build upon the knowledge and entrepreneurial skills of millions of agents in their mutual interaction, planning activities could not be discarded completely. The reason for retaining a part of them rests in the continual existence of hierarchies in parallel with markets. These hierarchies are of three types:

a/ Hierarchies of enterprises, whose necessary existence was explained by Coase /1937/. Markets cannot support all decisions and activities because the efficiency of markets can limited by transaction costs. Thus there is the role for managerial and organizational bureaucracy, whose main instrument of functioning are visions (strategies of global importance) and plans.

b/ Hierarchies of governments (central, regional, municipal), whose existence as decision-making bodies inherently cannot function without strategies and tactics incorporated into plans.

c/ Hierarchies of political parties that feed on individual entrenched interests that they amalgamate into political programs. Once such partial interests are socially contradicting, political programs cannot but be biased towards certain social groups. That may happen even if the causes behind such diversified programs may be identical.

It must be stressed here that these kinds of planning have their meaning only within the domains of three mentioned hierarchies. Their plans generally represent the hierarchies of priorities, to which there are assigned instruments (means) of implementation – forming thus another subset of hierarchies. In case of government policy design, we have illustrated such a mechanism in the box of Digression 2 (p. 16). The plans of all kinds must not crowd out (or distort) both the mechanism of markets and the autonomy of citizens (as the sovereign bearers of ethics and of freedom in consumption, entrepreneurship and employment). Once again the idea of complementarity (i.e. of the partnership) between government strategies (revealed in plans and policies), markets and individual freedom must be guaranteed, if such a social arrangement is to be sustained.

Let us look at the **transmission mechanism between the plans of political parties and governments**. In the Czech case medium-term strategies are formed before elections in form of "Election Programs" that are prepared by all competing parties. For example, the present winning party (ODS, belonging to the right) came with a thick book called "Blue Chance", where each shadow minister presented his/her priorities backed by past statistics and expected new trends influenced by their policies. However, the next step after winning the elections is to form a coalition. It is the specificity of the Czech political scene that any winning party does not have a simple majority in the Parliament [22]. The governments are formed by signing a Coalition Agreement – an act that often takes months of negotiations and public discussions. Strangely enough, the signed Agreements have been honored quite strictly, even though the government presents a wide plurality of interests followed by their parties. Coalition Agreement is less detailed than Election Programs of parties, even though it could be backed by indicative figures for some targets. It states the common guiding principles and agreed concessions to Election Programs. The most important task of the Agreement is to distribute the ministries among parties. The ministries are then managed by such a modified Election Program of the given party.

Annual plans for budget spending are the crucial instruments for keeping the cooperation of government coalition in mutual balance. Thus alternative visions among coalition must be harmonized already before the period of the budget. The Central Budget is structured according to ministries and its individual programs, while Regional Budgets are autonomous. In Czechia, as in member states of the EU, the national sovereignty is only partial. Some important objectives dealing with public goods (such as R&D, education, defense or environment) are given by the directives of the European Commission, which must be "internalized" into domestic laws and programs. Also the European Funds have their compulsory structure and 7 years' indicative figures.

Although regional and municipal elections are often combined with national elections, their campaign and outcomes can be very different. The ensuing complicated negotiations about harmonizing central and local decisions are simplified by granting local governments a clearly defined autonomy guarded by strict rules for fiscal management.

[22] Czech political system is characterized by its rather stable structure. There are two main rivals: right-inclined Democrats (ODS, akin to British Conservatives) and left-inclined Socialists (CSSD) that both fight for the margin of 30-35% of votes for each. Then there are the Communists with 16%, Greens with approximately 12% and Christians with 7%. Czech communists have a unique role: though no government would accept them into coalition, at the end it is them who decide at the margin about the most important policies.

Going back to the problem of coordination among such a diverse spectrum of democratic institutions, it is clear that there is a need for building institutions that overlap both the regional and the ministerial domains. CzechInvest was a typical example of such an agency where co-acting had to be shared across all political orientations in order to achieve aims of economic restructuring. Similarly some centralized financial institutions, be it the administration of European Funds, support of SMEs or Consolidation Agency administering the bail-outs (see Part III) had to be managed in a mode that was not subject to political cycles. The same concerns the institutions coordinating science, education, quality of products, environment or culture. In parallel to them there are active numerous NGOs that keep the discussion going from completely autonomous positions [23].

It should be stressed again at the end that above mentioned cases of planning deal strictly with the good governance practices at the level of government hierarchies only. As a general policy, the private sector (enterprises) is not forced to fulfill certain quantitative targets and no quotas limit their output. Only agriculture is subject to a quota system that is operated by the European Commission. Ideally speaking, the aim of government guidelines and institutions is to create incentives for more efficient allocation of resources and to minimize the impediments to entrepreneurship and growth. The reality can be different. Although central planning was completely abolished already in 1991, a significant indirect interference that limits the scope and flexibility of decision-making of enterprises is still present. There are regulations that limit the existence of negative externalities (e.g. pollution or crime). In addition to Acquis Communautaire (the so-called Brussels bureaucracy) there are still at least as numerous local regulations whose text covers tens of thousands of pages. Except for indirect generally valid incentives, the government can influence the private sector by "consolidation policies" that are rather discrete. Since bailouts and subsidies are not allowed after the EU accession, this vestige from the times of early transition can be implemented by means of government procurement contracts.

Nevertheless, Czech government "planning" converges to industrial policies coordinated at the level of European Commission, which have clear general rules that are market-compatible. Europe will remain differentiated, though. The local differences will be determined from the grass-roots: by the talents among local entrepreneurs, the quality of education, local bureaucracy that is not subject to rent-seeking and by individual preferences between leisure and work. At the end, it is the civil society and its culture that decide about the long-term development.

[23] As an example, let us consider the NGOs monitoring of the government policies towards FDI promotion. The most active civil society group is called GARDE (Global Alliance for Responsibility, Democracy and Equity), which screens legal and environmental aspects of FDI promotion schemes, issues analyses of the impacts of FDI on the society and supports the litigations of individuals who suffered dammage from FDI. It proposes revisions of laws that regulate the FDI entry. The network of GARDE covers the whole country and it has earned prestige in the media.

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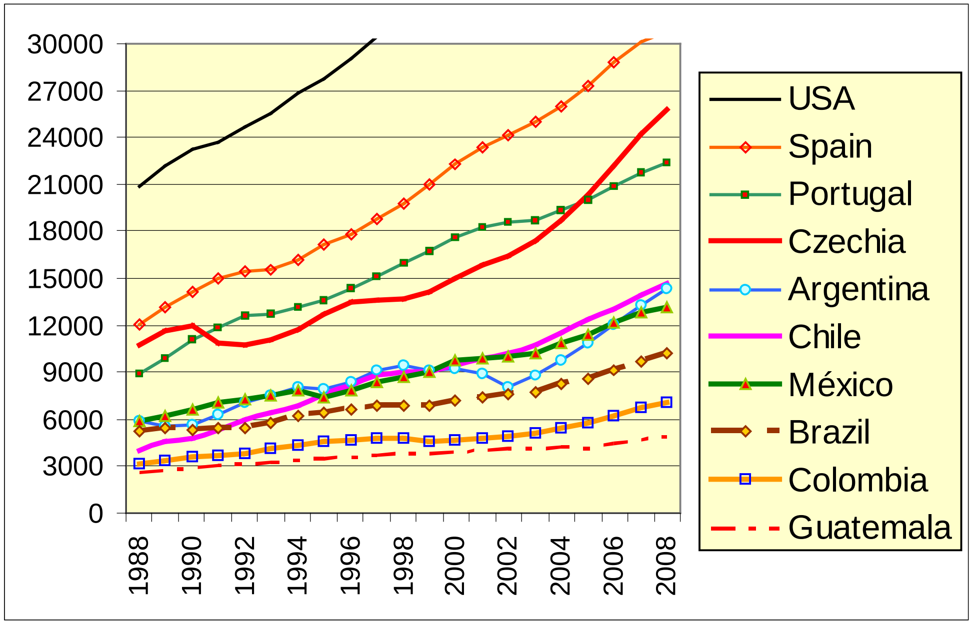
APPENDIX 1:
Comparison of historical paths of development of Czech economy with some other countries.

Figure A1: Growth trajectories of Czechia, Portugal and Spain in comparison with six countries of Latin America
Data are in US $ based on the GDP per capita at purchasing power parities.



Source: IMF and World Bank, Economic Outlook, 2008, http://www.econstats.com/weo/V019.htm

The data indicate that Czechia, Portugal, Spain and Argentina had in the past interwoven development. Historically, all four had problems with dictatorships and distorted market performance. After 1992 the Czech economy started to catch up with Portugal. After 1998 Argentina lost in the race for convergence with the other three. The remaining five Latin American countries had also shared trajectories, where Perú, Colombia and Brazil lost subsequently the pace with Mexico and progressively rising Chile. Catching up with Chile could be a motive for an improvement in their economic policies.

Table A1: Parallels in the Czech, Spanish and Argentine development (GDP 1913-2006). An international comparison of ranking.

Country	1913	Rank	1929	Rank	1938	Rank	1950	Rank	1996 CER	Rank	1996 PPP	Rank	2006 CER	Rank	2006 PPP	Rank	Country
USA	3772	1	4909	1	521	1	6697	1	28996	8	28638	2	43883	6	43538	1	USA
Ireland	1680	16	1900	17	252	12	3450	9	20128	17	20192	15	53090	3	42081	3	Ireland
Canada	2773	4	3286	4	377	4	4822	2	20757	15	23073	7	35568	14	35742	5	Canada
Austria	1985	9	2118	14	179	15	2123	17	29086	7	23566	6	40849	7	34423	7	Austria
Japan	795	23	1162	23	112	23	1116	23	37357	2	23675	5	38326	11	32617	9	Japan
Australia	3390	2	3146	6	380	2	4389	4	22067	13	21308	12	34760	15	32296	10	Australia
Finland	1295	20	1667	18	178	16	2613	14	25160	12	19828	17	40604	8	32153	11	Finland
Britain-UK	3065	3	3200	5	378	3	4164	5	20519	16	20673	14	39617	9	31561	13	Britain-UK
Germany	1907	11	2153	13	354	6	2508	15	29112	6	22633	8	36153	13	31472	14	Germany
Sweden	1792	13	2242	10	327	7	3874	7	30609	5	19909	16	43933	5	30751	15	Sweden
Italy	1773	14	2089	15	167	18	2104	18	21488	14	21627	11	33080	16	30672	16	Italy
France	1934	10	2629	9	236	13	3038	12	26075	11	20695	13	37007	12	30342	17	France
Spain	1590	17	1620	19	132	21	1683	22	15515	18	16373	18	28603	17	26009	18	Spain
Czechia	1890	12	2205	11	206	14	2909	13	6065	20	13918	19	13035	19	20563	19	Czechia
Hungary	1340	19	1598	20	141	19	1847	19	4513	21	9420	22	11885	20	17733	20	Hungary
Slovakia	1075	21	1375	21	138	20	1785	21	3887	23	9847	21	10326	21	17265	21	Slovakia
Poland	810	22	1360	22	128	22	1827	20	3974	22	7807	23	8602	22	14137	22	Poland
Argentina	1770	15	2036	16	172	17	2324	16	7729	**19**	11142	**20**	4708	23	13813	23	Argentina
Country	1913	Rank	1929	Rank	1938	Rank	1950	Rank	1996 CER	Rank	1996 PPP	Rank	2006 CER	Rank	2006 PPP	Rank	Country

Remarks: PPP = purchasing power parity; CER = nominal values converted to dollars at commercial exchange rate.

Years 1913, 1929 and 1950 are in constant US $ at prices of 1980. Years 1938, 1996 and 2006 are in current prices.
The list of 23 compared countries excluded those with less than 1 million inhabitants and four countries, for which there were no data:
New Zealand, Slovenia, Greece and Portugal. Zealand was always better off than Czechia but not the others. For saving the space the following rich countries were deleted (in descending sequence of wealth): Norway, Denmark, Switzerland, Belgium and Netherlands.

Sources: Years 1913 and 1929 : Maddison (1989); Year 1938 : Kaser, Radice (1985), p. 532, Butschek (1995) and Solimano (1993), p.14
Year 1950: Good (1996), Butschek (1995) and Maddison (1989); Year 1996: World Bank (1998); Year 2006: IMF World Ec. Outlook, 2007

The evaluation of welfare ranking by mere GDP figures can be misleading when we compare societies with widely different cultural heritage and where the dispersion of wealth among population is not uniform. Countries in Eastern Europe (especially those with a long communist, totalitarian and anti-religious history) can therefore differ substantially from countries in Latin America in their preferences of certain values (public versus private life; individualism vs collectivism; financial vs spiritual sources of happiness; role of education; etc.). Therefore the importance of alternative indicators of prosperity is essencial.

In sociological researches Czechia is characterized by the importance of civil society, i.e. by the tendency to supplement market provisions and the reliance on the State by private initiatives, solidarity and participation in collective action. This feature is also related to thriftiness (e.g. to very high saving rates of households out of income), reliance on education and low trust to official politics and economic elite. Czechia is therefore more akin to Scandinavian countries (similarly as it is in Austria) than what can be observed in continental or southern Europe. The importance of individualism and the belief in material values in Czechia is therefore much less significant than what can be observed in the Anglo-American world. At the same time Czech society is also less "organized" in the meaning of trust to institutions, rules and hierarchies, which makes it quite different from both the Scandinavian and the Anglo-American countries.

Human development index (see http://hdr.undp.org where this index combines GDP with longevity and education places) places Czechia very close in its ranking to the position in the GDP per capita. E.g. in 2004 Czechia ranked no. 30 out of 177 countries. The position is much worse what concerns the corruption perception index (see http://transprency.org). In 2006 Czechia ranked 46th among 163 countries of the world, lagging significantly behind Spain or Portugal. High corruption implies that the society is not offering sufficient space to improvements due to working merits, personal development, mobility or social inclusion. Here we can see that Czech society seems to be in conflict with its own social values.

The next table A2 shows a more detailed comparison of the evolving GDPs in Czechia, México and Guatemala. We can see that Mexico had higher GDP per capita in nominal USD than Czechia in the period of 1991-2001. The reason for that was a highly undervalued Czech Koruna during the first 10 years of transition. The high Czech real growth during 2001-2008, enforced by fast appreciation of Koruna, resulted with catching-up in 2002 and overtaking of the Mexican economic level by the Czech economy.

Table A2: Lagging and catching-up in the Czech GDP 1989-2008.

Czech GDP per capita vs. México and Guatemala Sources: Econstats, the WB, 2008

NOMINAL GDP $ per capita:

	Czechia	México	Guatemala	Méx/Cze	Gua/Cze
1989:	$ 5 589	$ 2 730	$ 963	49%	17%
1991:	$ 2 636	$ 3 709	$ 1 035	141%	39%
2001:	$ 6 077	$ 6 282	$ 1 714	103%	28%
2008:	$ 20 607*	$ 8 914*	$ 2 619*	43%	13%

PPP GDP in intl $ per capita:

	México/Cze	Guatemala/Cze
1989:	53 %	24 %
1991:	64 %	28 %
2001:	62 %	25 %
2008:	51 %	19 %

APPENDIX 2:
Digression 5: Capital Acquisition, Banking and Debt Relief Policies

The reversal of the banking policy in 1997 was the most important institutional change during the stabilization period of 1996-2003. That event was a part of more substantial changes, whose context had its history. Whilst the growth in the communist system was based on massive investments containing little innovation and the country was flooded with inefficient physical capital, the first years of transition clearly showed that extensive parts of the old capital must be written off and new investments must start from scratch. The country sunk suddenly to a period of an intensive capital shortage. Future development depended vitally on the rise of efficient banking intermediation and capital markets. Unfortunately the communist system new nothing about both. All finance in the country was ruled by a single national mono-bank.

Until 1997 the presence of private and especially foreign capital in the Czech banking was just symbolic and commercial banks, notwithstanding their formal de-etatization, remained still a part of the State fiscal responsibility. Accepting the risks of moral hazard and corruption, due to weak banking governance, became a standard approach to loan strategies during 1993-2000. The lure was so enticing that out of 38 new indigenous banks only three avoided falling into bankruptcy or did not have to be bailed out by the public finance. In 2002/2003 the last two banks that remained in domestic hands went to bankruptcy.

The case of mounting debt defaults and the policies applied for their liquidation require a special attention. As the Czech commercial banks became main intermediaries in the privatization schemes, their portfolio of loans in 1998 was composed by 34% of classified credits (21% of GDP) [24]*. The bailout of the Czech banking sector was the main part of the Government subsidy program. Its costs were estimated by the Ministry of Finance to be 578 billion CZK* [25]*. Various subsidies and bailouts paid by the other State institutions (like the Fund of National Property, Czech National Bank, etc.) are excluded from these estimations. In addition, "implicit subsidies in kind" should be included into the costs of government stabilization packages. We can estimate that altogether the value of bad debts, defaults and contract breaching (i.e. including the unpaid deliveries among enterprises, wages, social and healthcare benefits, taxes, etc.) was at least a value proportional to 50% of the GDP in 2000. If valued at PPP, such explicit and implicit transfers from the public to private sector could reach $ 74 billion (valued at PPP and cumulated for 1991-2003). The access of privileged insiders, representing a tiny part of businesses, to such riches (the GDP in 1999 was $ 148 bil.) was definitely a wrong incentive for prosperity in the productive sector. Defaults of such an extent have hardly a parallel in developed market economies during peacetime.*

The bailout of debts accumulated in commercial banks within mere 10 years and subsequent sales of banks to renowned foreign owners became a dominant government policy since 1998 until 2005. A similar problem was present in many other transition countries (see Figure A2). The metamorphosis was staggering: the efficiency of restructured banks was often higher than that of their mother companies.

[24] *In some other countries the peak came in 1999 when the share of bad loans per total loans was 40% in Slovakia and 37% in Romania, while it was only 3% in Hungary and Estonia and 15% in Poland (Statistics of the World Bank, 2000). Remark: such policies of growth are not limited to transition or developing countries. The philosophy about the growth driven by subprime mortgages in the US was motivated by similar trains of thought.*

[25] *This would be approximately $ 17-22 billion at commercial exchange rate and a double of that at the PPP standards.*

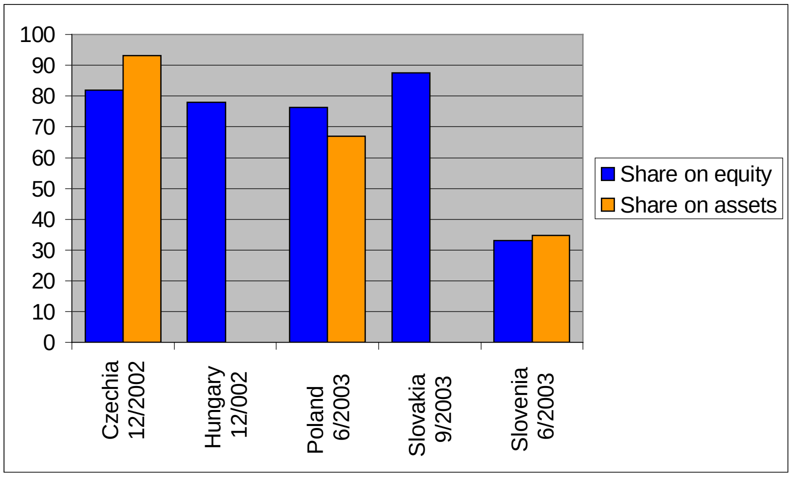


Figure A2: Foreign ownership of the banking sector in central Europe, 2002-2003
Sources: Statistics of the national banks in Annual Reports, 2004

Stabilization of the financial sector re-directed the monetary policy to qualitatively new objectives. With the inflation rate decreasing to 1.8% in 2002, the interest on loans fell to mere 5%. Since that time Czechia could have one of the lowest interest rates in Europe that boosted the investments. The country was ready to a reversal in its financial flows – formerly a net borrower has been gradually changing to a net creditor. With the end of large privatization of enterprises in 1997 and the privatization of banks in the next 5 years, the banks became extremely cautious in their credit policies. But so did the enterprises. As a result, in the short run the borrowing in the majority of indigenous firms decreased sharply. Those who were most harshly hit were the large firms without foreign capital. However, as the competition among banks increased, some banks introduced special schemes for credits to SMEs where indigenous owners dominated. So, relatively to large or foreign enterprises, the SMEs were gradually improving their access to loans and their handicap was disappearing.

An important aspect of healthy financial standing of enterprises are bankruptcy procedures, as a natural complement of enterprise expansion. Inefficient firms should release their resources to efficient ones at low transaction costs and the debts they accumulated should be redeemed by creditors without high litigation losses. Even though the efficiency of the banking/financial sector improved in many transition countries quite miraculously, the changes in the efficiency of bankruptcies proceeded much more slowly.

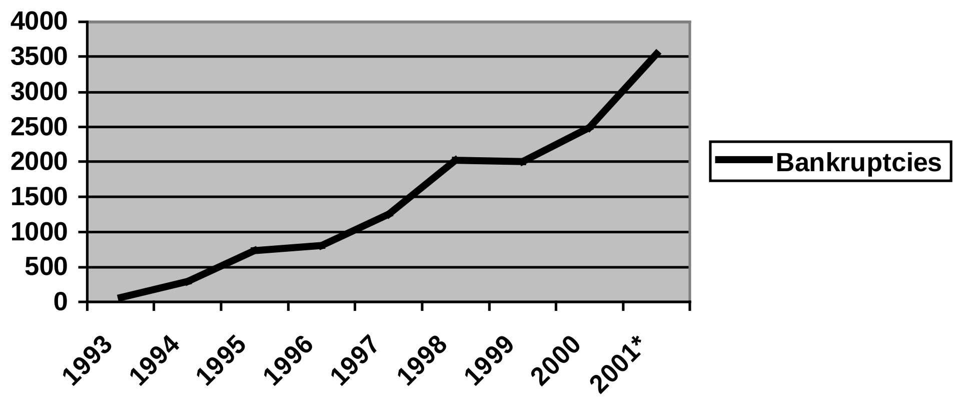


Figure A3: Number of bankruptcies in the Czech economy
Source: Czech Ministry of Justice, 2002. The data for 2001 were provisional.

Figure A3 depicts the evolution in the number of bankruptcies in the Czech economy. In 2001 there were 10580 claims placed by creditors on bankruptcies. Unfortunately the average duration of a bankruptcy court procedure was 18 months in 2000. In 2000 there were 165000 limited liability companies and 13000 joint-stock companies. Their liquidation rate was thus 6% if we consider that around a quarter of them were in red for a long time. On top of it, Czech creditors received one of the world's lowest rates of compensation because the average length of bankruptcy final liquidation was 6 years. It became clear since the mid of 90's that bankruptcy laws became the weakest link in the restructuring of the Czech economy. Since 2001 there were numerous proposals in the Parliament for a change. Unfortunately, the political pressures of the indebted firms were stronger.

We can see that government policies of financial relief were changing in time. They gradually shifted from public finance on private banking. Also the role of capital market flotation was gaining in strength. A complete liberalization of financial intermediation and financial flows with abroad is recognized to be an economic success that brought the country efficiency and prosperity, even though it took 10 years to win the political battle for such policies. In some other fields, like in bankruptcy laws, the battle for this "nervus rerum" is still going on.