

Small Businesses and Private Entrepreneurship during Transition: The Case of the Czech Republic

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Abstrakt

Nesmírně intenzivní a spontánní expanze soukromého malého a středního podnikání v České republice v období 1990-93 probíhala současně s neméně dramatickými změnami v alternativní (stínové) ekonomice. To také vysvětluje, proč je rozměr tohoto sektoru stále statisticky podhodnocován. Kořeny nových podnikatelů lze často sledovat hluboko až do uspořádání bývalé totalitní společnosti - do výrazně se konstituovaných skupin nomenklatury a "šifrbů" tehdejší stínové ekonomiky. Šance zbývající části obyvatelstva byly pak pro vstup do třídy nových kapitalistů výrazně oslabeny z důvodu jejich nedostatečné vybavenosti kapitálem nejrůznějšího druhu. Makro a mikroekonomická politika byly významným faktorem, který rozvíjel, respektive tlumil produktivní orientaci podnikatelů nebo ji případně odkláněl do neproduktivních alternativ. Dosažitelnost kapitálu a institucionální podmínky ovlivňující fungování trhů a chování podnikatelských subjektů zůstávají nadále hlavními faktory ovlivňujícími rozvoj celého hospodářství. V závěru práce se diskutují problémy současného podnikatelského klimatu a nastiňují se některé alternativy hospodářské politiky.

Abstract

The impressive and spontaneous build-up of small and medium-sized private businesses in the Czech Republic between 1990-93 coincided with similarly dramatic changes in the "alternative" (shadow) economy. This is the reason why the size of the private sector is significantly statistically underestimated. The origins of the new private entrepreneurs can often be traced to communist times - to the group of nomenklatura and the group of illicit marketeers. The remaining part of society was partially handicapped in its entry into the new capitalist class because of its lower endowments of capital of various kinds. Macro and microeconomic policy was an important factor in promoting, re-directing and checking the productive orientation of emerging businesses. The formation of capital and the institutional conditions influencing both the efficiency of local markets and the behavioral patterns of entrepreneurs, seem to remain the core of problems affecting the development of the whole economy. At the end of this paper, present small businesses environment is discussed and some policy recommendations are raised.

The most important prerequisite for becoming an

entrepreneur is the ownership of capital.

M. Kalecki (1954)

1. The Position and Role of Czech Small Businesses

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

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

We cannot directly quantify the number of practising entrepreneurs in the country from these figures since some licences could be issued for the same entrepreneur, or some business entity could be represented by more than one entrepreneur. The statistics from the Czech Business Register in January 1993 assessed the total number of registered entrepreneurs at 1,060,222 persons, which would represent 22.5% of the whole labour force of the Czech Republic. If we add to this number their working family members and other employees, we can estimate that approximately a third of the Czech labour force may be fully or partially associated with entrepreneurial activities in the generic private sector with stabilized ownership and property rights (this is also the official estimate of the Ministry of Labor for June 1993). These estimates imply that the boom in the SMEs was the most dynamic economic factor behind the stormy changes in the

new capitalist developments in Czechoslovakia which were initiated practically from scratch in November 1989. **The crucial aspect of this occurrence is that it evolved spontaneously from the grass roots of society.** Without understanding the background of this fact and its effects over the whole economy, one cannot get to the fundamentals of the Czech economic transformation, its successes and problems.

The following working hypothesis can now be raised: Even though the generic private sector (voucher privatization excluded) officially produced 21.5% of the GDP in 1992, its statistically unrecorded activities (including illegal or semi-legal activities) may have substantially compensated for the officially reported fall of 26 % in total production between 1990 - 1993. Even the factual Czech effective domestic production (though substantially higher than what the official figures of the GDP might indicate) can be characterized to have been subjected to a "long-lasting severe recession". However, a qualifying provision must be added: the economy experienced a severe structural shock on the demand side, followed by an intensive reallocative shakeout and falling output in many traditional industries, while the average household welfare could be characterized as stagnating or even rising due to improved quality, expansion in the service sector, changed structure and the disappearance of shortages and queues.

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

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

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

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

a) In the period of Jan 1991 - Apr 1992 it was recorded at the Federal Statistical Office that 450,000 persons, i.e. at least 6% of the total CS labour force, had quit work in state companies or left schools and, at the same time, neither registered as unemployed nor entered work domestically or abroad. It is assumed that they, to a large

extent, "disappeared" into the black and the shadow economies. Without doubt, this trend continued during 1993. The Statistical Office estimated that 300,000 persons were active in the shadow economy in 1991. The OECD estimates that in 1992 350-400 thousand persons of productive age may have been so employed in the Czech shadow economy alone (see OECD (1994), p. 15).

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

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

d) Many managers of corporations undergoing privatization under the voucher scheme, or managers in restituted firms, have used the environment of weak ownership control to find for themselves a safe niche allowing them to exercise their own shadow entrepreneurial activities by exploiting the resources and abusing their power over the company which hired them (Prague Post, 23.3.94, p. 5).

e) The output and sales of many private companies is, to some extent, unrecorded and thus under-estimated by official statistics, tax evasion being the main motive. The booming years for profit tax evasion were 1991-92, while the introduction of VAT in January 1993 has checked its further growth. On the other hand, the new scheme's two tier system of tax rates (23 and 5 %) offers new opportunities. E.g. an 18 % additional profit can be earned if some commodity can be easily declared for the lower 5 % rate, while the sales price includes the 23 % rate. The tax frauds from the retained VAT and excise taxes charged on diesel oil sales (while declaring it as the heating fuel) in 1993 were officially estimated to run up to 5 bil. Kč. More speculative estimates inferred from the sudden drop in diesel oil sales after the introduction of VAT and tax frauds from the oil re-export, calculate the potential tax loss at 20 bil. Kč (Telegraf, 28.3.94). The excise tax losses due to tobacco smuggling was officially estimated to be 1-1.5 bil. Kč in 1993. The smuggling of clothing is estimated to cover 30 % of sales, i.e. at least 1.5 bil. Kč (Profit, 21.11.91, p.4). Trafficking in antiquities and objects of art abroad is estimated at over 2 bil. Kč per year.

f) The construction sector, which experienced one of the most dramatic restructurings during the transition shows many ambiguous features. On one hand, it was the sector with the fastest process of privatization. In 1993 it covered 73 % of output. State construction behemoths disintegrated spontaneously into small private working units based on intensive subcontracting. The nature of their business makes the tax and the employment monitoring very difficult. On the other hand, the officially reported output in construction declined more than in other sectors. E.g. its share of the CS GDP

declined from 8.7% in 1989 to 6.6% in 1992, while its share of total employment in the Czech Republic has risen from 8.2% to 9.7%). At the same time, wages in this sector after 1989 steadily grew much faster than average, and its private firms were overloaded with contracts. One possible explanation of this phenomenon would be that the construction sector is systematically underreporting its activities.

g) A similar argument, as related to the construction sector, can be raised with the service sector. With its new booming private ventures and the share of total employment boosting to 47% in 1992, it provides even more potential space for underreporting.

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

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

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

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

l) There were 76,000 people registered for work abroad (e.g. for daily commuting to Germany) at the end of 1992. The real employment of Czech citizens abroad may be significantly above 100,000 jobs, with their relatively lucrative income being predominantly spent at home. The Bavarian Chamber of Commerce estimates that Czech daily commuters alone bring from Bavaria at least 300 mil. DM per year (Hospodářské noviny, 22.7.93, p. 6).

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

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

It can be roughly estimated from these facts, by assuming that unreported employment

was as productive as in the rest of the economy or by adding the unreported revenue to the official figures, that the actual production must have been significantly higher than the officially reported one. It can also be roughly estimated that at least 15%, but potentially even up to 30%, of the labour force in the Czech Republic may be engaged (as a regular or temporary profession) in the shadow or the black economy. If their income were to be added to the official figures of the GDP (indicating the fall in output for 1990, 1991, 1992 and 1993 by -3, -16, -7 and -1 %), **the alleged dramatic decline in the standard of living over the last 4 years may not be a reality**. Thus the unrecorded activities of the second economy might significantly compensate for the fall in the official figures of the national income. Apart from the second economy, there is another reason for an incomplete and unreliable statistical recording. The state system of statistics suffered a great deal from the breakdown of the hierarchical structure of central command, the proliferation of new firms and the changes of ownership. Many skilled statisticians moved to better paid jobs in the private sector. Also the whole system of statistical reporting was nearly completely modified. While the errors and omissions in reporting from all economic agents (both small and big) have risen sharply, the capacity to prosecute them decreased. What is of more importance is that this situation has been widely expected, tolerated and thus abused. Combined with the infant tax enforcement institutions, the resultant bias leads to a one-way loss of information and the underestimation of income statistics. The distribution of undetected "errors" has a natural tendency to be biased to the negative tail of the sample, i.e. in favor of the suppliers of information.

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

- * No strikes.
- * No visible starvation or extensive pauperization.
- * The belief of the median Czech voter (revealed in many public opinion polls) that layoffs, unemployment and bankruptcies should be expected to rise in the future and that they are a necessary condition for future prosperity.
- * Reversal of emigration. E.g. in 1992 only 468 persons emigrated from the Czech Lands to the West, while 7332 persons settled permanently into the country (Hospodářské noviny, 21.4.93, p. 1). This development is incompatible with the patterns of 1968-1989 when the average annual CS emigration numbered 12,000 persons.
- * Increased propensity of households to save from their income. The behaviour changed dramatically from a steady average of +3.3% during the whole 1980s to a rock bottom -2% in February 1991, to an average of 13% in 1992 (when the stock of household savings nominally increased by 25 %) and to approximately 8 % for 1993 (Czech National Bank statistics).
- * General satisfaction of the population with the living standards. E.g. in March 1993 72 % of the Czech respondents in a public opinion poll declared that their standard of living was either higher (31%) or the same (41%) "as in the past". Similar opinions were reported in January 1994 when dissatisfaction was revealed (in three different and independent surveys) by 8, 23 and 36 % of the questioned households.

- * High level and steady rise of outgoing foreign travel, especially for summer holidays in Spain, Italy, Croatia and Greece and skiing in the Alps. In 1993 the expenditure on tourism increased by 9.5% to 505 mil. \$ (i.e. approximately half of what the average Spaniard spends on foreign travel).
- * Rise in purchases of some high cost durables, e.g. the sales of cars increased from 137,000 in 1987 to 267,000 in 1992, the majority of which were imports from the West. A similar pattern was observed in Poland (see Winiecki (1993)), where the majority of households significantly increased their wealth and the consumption of durables during transition.
- * Difficulties of some businesses in filling vacancies even in areas where official unemployment figures are high. Some unemployed may also ask for wages which are well above the national average.

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

If our reasoning is correct, then in 1993 the effective Czech domestic product, income and expenditure for 1993 could have been significantly higher than reported. As a working hypothesis, let us assume intuitively that **the second economy (in its widest definition) might contribute additionally 17 - 25 % to the officially estimated GDP.** Of course, the main engine of the hidden dynamics is not to be found in the big old corporate sector, where production was recorded quite reliably and where the development of the shadow economy was checked by other institutional barriers. Here we cannot refute the hypothesis of a substantial real downside in the corporate sector in 1990-93. The explanation thus remains with the effectively privatized businesses which in 1990-93 could be found preponderantly outside the corporate industrial sector - i.e. in the SMEs. At the beginning of 1994 the share of the SMEs (including the unreported private activities), which represent the generic private sector with solved ownership, may thus even comprise 35-40 % of GDP. This is still less than potential 60 %, as is normal in the developed market economies. On the same grounds, the non-state sector (including the firms subject to both voucher privatization schemes) could have contributed by more than the officially estimated 67 % to the effective GDP at the end of 1993.

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

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

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

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

If we accept the reasoning that the SMEs as public goods provide external social benefits which cannot be commercially rendered by other autonomous business activities and that these benefits are of exceptional importance during times of transition, then it would be expected that **the conditions for the development of the SMEs would become the focus of fundamental interest for the Czech government, other institutions representing the State and their economic policy.** However, in many aspects this has not been achieved.

2. Origins of Czechoslovak Entrepreneurship

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

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

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

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

- Division of labor and specialization in labor and human capital intensive industries.

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

The Nazi occupation of Czechoslovakia in 1939-1945 severely suppressed practically all of the above mentioned factors. The short period of left-wing CS capitalism in 1945-48 was marked by extensive nationalization and the confiscation of property, and by the proliferation of theories of central control. However, some features of small-scale entrepreneurship (the ethic of serving the consumer, esteem for the innovator and the hard worker, self-reliance, independence and sole responsibility of the decision maker, etc.) were retained during 1939-48 and survived in a hidden form until the late 1960s, even though by 1964 practically all private property was liquidated. These were the first

roots of the present Czechoslovak entrepreneurship, originating in Czech capitalism.

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

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

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

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

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

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

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

TABLE 1: Characteristics of two types of entrepreneurship in Czechoslovakia

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

Table 1 gives a review of the most typical characteristics in which these two groups differed. Both of these entrepreneurially oriented groups also shared some similar characteristics and values:

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

it as their own property and appropriate a part of the accrued profits or wealth.

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

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

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

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

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

Even though some segments of the heterogenous group of outsiders are endowed with a high level of human capital (e.g. among the intelligentsia or engineering staff), it was **the social capital (or more specifically the personal network capital)**, as subsets of the human capital, that really mattered (Bourdieu (1986), Sik (1993)). They represent that part of human capital which covers inter-personal links in an exclusive coalition (network of closed informal contacts), built for sharing (insider) information, favors or privileges, having the implicit purpose in economic gains, namely in gains of wealth and power. Unlike physical capital, the use of social (network) capital is oriented primarily to the task of redistributing existing opportunities and not to the creation of new values. As a social phenomenon, network capital is not a complement to perfect market behavior. In fact it relies heavily on the concept of "voice" (see Cyert, March (1972)) in the environment of market imperfections, market failures and bureaucratic decision making.

The broader concept of capital is based on those stocks of assets which:

- take a long time to accumulate,
- can be personally appropriated (owned and conserved),
- bring certain returns (yields) to their owner, thus reproducing his/her wealth.

What is the essential property of the capital in the case of the economic transformation is its transferability (conversion) to alternative uses, i.e. independence from the technological and institutional setups (Leamer (1993)). The speed of convertibility of capital in transition seems to be of key importance for the success of becoming an entrepreneur. The money in cash form and the social (network) capital are best suited for this purpose. The nomenklatura and especially the operators were practically the only domestic groups having available liquid financial capital. But, as the total endowments of the asset money in all post-communist countries were lagging far behind the requirements for starting business transactions, the next capital available for solving that constraint was social (network) capital. As opposed to financial capital, the build-up of social (network) capital was booming during the days of totalitarian socialism, because it was the essence of the local bureaucratic power game, the shadow management systems and the parallel markets.

Because of the highly uneven distribution of transferable capital of all kinds at the end

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

3. Macro and Microeconomic Policy Conditions for Emerging Entrepreneurship.

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

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

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

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

However, the whole process had some drawbacks which became apparent only after deeper scrutiny of the microeconomic developments. First, the government assumed that functioning markets would develop automatically once the macroeconomic conditions were favorable. (For a more extensive discussion of the industrial policy issues see Landesmann (1993) and Aiginger (1993).) Therefore no industrial policy was considered necessary for a long time. Even though the Czech government has never conceded in its rhetoric that it would follow the industrial policy schemes, in reality some general and many discretionary concessions were made, especially after V. Klaus became Prime Minister in June 1992. Let us now discuss some of the more visible aspects of the current economic policy of the government and their relationship to local entrepreneurship.

**Table 2: Selected Official Indicators for Czechoslovakia (1989-92)
and the Czech Republic (1993)**

I n d i c a t o r	1989	1990	1991	1992	1993 ⁵
Nominal GDP ¹	795.5	811.3	977.8	1059.9	899.0 ³
Real GDP ² % change	1.9	-1.5	-16.1	-7.1	-1.0
GDP per capita in \$ (1\$ =28 Kčs)		1900	2240	2400	3100
GNP Deflator %	101.2	108.7	153.6	111.2	118.3
Personal income ^{2,5} % change	+2.2	-0.2	-27.1	5.4	6.0
Non-state sector % of GDP ⁵	2.0	5.0	10.6	19.5	67.0
Private Consumption ^{2,5} % change	+2.8	+2.9	-24.0	+8.7	+2.9
Public Consumption ^{2,5} % change	+7.6	-0.8	-9.1	-3.7	+6.1
Fixed capital invest. ^{2,5} % change	3.2	-2.1	-17.7	3.8	15.0 ³
Change in inventories ^{2,5}	3.8	12.1	16.6	-27.0	-46.4
Unemployment % (end of year) ⁵	0.0	0.8	4.1	2.6	3.5
Exchange Rate (Kčs/\$), average	15.1	18.3	29.5	28.3	29.0
Budget deficit or surplus ¹	-3.5	+4.2	-12.0	-16.7	+1.1
Current account balance ⁴	400	-1105	356	226	620
Balance of payments ⁴ (surplus=+)	+590	-1102	898	-120	+2950
Net foreign investment ^{4,5}	171	120	511	947	1540
External Debt ⁴	7900	8100	9400	9600	8700
M2 ¹ , % change	4.4	3.7	27.3	25.4	17.4
M1 ¹ , % change		-10.0	+26.7	+15.0	+14.6
Average lending rate to firms %	5.0	6.1	15.4	13.8	13.0 ⁵
Number of Banks	4	9	28	46	56
Loans ¹ , % change	-2.0	-7.7	+14.5	+13.7	+17.5
Foreign Exchange Reserves ⁴		1200	3300	4300	6200

Source: SBČS, Czech National Bank, Czech Statistical Office, PlanEcon (1994), Bulíř (1993)
Notes:

¹billion Kčs, nominal; ²billion Kčs, 1984 prices;

³provisional estimate; ⁴million USD;

⁵Czech Republic only

a) Commodity markets. At the beginning of 1992, after two years of sustained pressure, the price market clearing mechanism became operational on both the supply and the demand sides; shortages disappeared. However, many companies in the pre-privatization agony were not able to bring their products to (in some cases even unsaturated) domestic markets. It is a paradox that many cheap products of domestic origin could not succeed in getting through to the marketing stage and got stuck in unsold stocks. The final demand for cheap local products often either remained unsatisfied or was met by imports of an inferior quality. Significant price controls were retained in the housing sector and the public transport; minor price regulations remained for fuels, energy and some agricultural products.

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

c) Market efficiency. The experience of all developed market economies shows that it would be doubtful policy to assume that the best role for the government in creating competitive markets, ownership structures and entrepreneurship is to abstain completely from any involvement. The initial setup of the post-socialist markets and ownership is confronted with too many non-economic interferences, imperfections, failures and insufficient provisions of public goods (see Benáček (1992)). The paradox here is that hardly any government and its bureaucracy can be entrusted to be a direct effective provider of market efficiency. However, the responsibilities of the state (regardless of its political leaning) are irreplaceable, and wider than what the already established markets might otherwise require (see Zamagni (1993)). The state as an organizing agent is the body finally responsible for:

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

The mentioned responsibilities remain a sufficient burden to overload any government, not only a frail governmental coalition of a society in transition. Naturally, up until now the Czechoslovak and Czech governments were not able to concentrate systematically on these tasks and relied quite often on incidental solutions, spontaneous activities of enthusiasts and on the ethical instincts of society. However, the enthusiasm and ethical assertiveness had already faded away during 1990-91, as daily experience was showing that the "new freedom" was neither a game with platonic rules, nor one where the gains are equally distributed among all. The bulk of Czech society, being more aware of the contradictions of newly emerging

reality, responded with their typical sarcastic skepticism (albeit quite disciplined). The widespread, seemingly pessimistic expectations, subjecting all positive achievements in the building of the market economy to questioning, is a typical and necessary self-defence for all outsiders. In its criticism it is in fact quite constructive, if the future individual chances are subject to greater openness.

d) Stock market. It took three years and a lot of government support to prepare conditions for a functioning market with commercial paper. Two competing stock exchanges, opened in June 1993, and hundreds of stock brokers, have shown the ability to provide competent services for the seven million local stockholders. After very shy trading and falling stock prices during the previous three months, the market recovered from a price index of less than 500 points in October 1993 to 1045 in January 1994. The sales on the Prague Stock Exchange alone in the first 10 months of trading reached 26 bil. Kč. However, the transfers of equity outside the stock exchanges were estimated to form 80-90% of all transactions. In 1993 the foreign portfolio investment (\$1060 mil.) and the foreign loans to firms (500 mil. \$) became a more important resource of capital than the total of FDI's (550 mil. \$). The majority of stock trading abroad was channelled through the stock market in Vienna. Its turnover of the Czech and Slovak commercial paper in 1993 was approximately three times higher than what was recorded on the Prague Stock Exchange. The catastrophic expectations of some experts that the voucher stockholders would immediately swap their equity for whatever cash it may bear, and thus bring a collapse of the market, were completely flawed.

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

e) Money market. In all transient economies banking and financial services remain one of the main bottlenecks of growth (see Phelps et al. (1993)). This paralytic infection is deeply seated in the central institution of capitalism - the flow of money - attacking primarily the capital market. The Czechoslovak government, being always aware of the key role of money in emerging markets, took many measures to avoid risks. However, the tasks seem to be much harder to accomplish than anyone expected. The country is constantly fighting global capital shortage, even though not all firms are under a taut capital constraint. The average real interest rates continued to be negative in 1993. (E.g. the real yield on deposits and bonds for July 1992-September 1993 vary between zero and -12%.) The interest tax of 15% on deposit and 25% on commercial paper results in even less of an incentive to save. Private business access to bank credits remains extremely difficult, a situation that is often solved by forced inter-firm credits (i.e. by defaults in payments). The credit crunch in the private sector did not subside even after the M1 and M2 supplies significantly increased in real terms in 1992. The situation became even tighter in 1993 when M2 increased by 16.7%, while the CPI increased by 18.2%.

Massive privatization, continuing at least until 1995, will cause a further crowding-out of credits for business transactions if the monetary policy does not expand further. Support of the National Property Fund has not been significant until now, as approximately 80% of its proceeds from privatization were diverted to prop-up the ailing corporate and banking sector in 1993. No change in this policy is planned for 1994. The situation on the loan market in

1992-93 was marked by both a lack of supply of liquidity and failing intermediation facilities. The solution to this problem by economic policy has become more of a riddle than ever, as the government slowly resigns from its market-oriented cure of the causes, in preference for more bureaucratic control over the effects.

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

To sum up the situation in the Czech money market in 1993, the following problems can be outlined. The supply side was marked by insufficient savings (insufficient relative to the task of transformation) and by the money supply squeeze. The tight monetary policy had to be reinstalled at the beginning of 1993 in order to check both the inflationary pressure of the monetary separation after the Czecho-Slovak partition and the introduction of the VAT system of indirect taxation. On the demand side, there was an enormously growing demand for transaction money related to property buy-outs, new business revamping schemes and the overheated private sector. With the excess demand for credits in the situation of incomplete information and high risks, the ensuing need for credit rationing became a necessity. That would normally lead to high profit margins of the banks, high average interest and its wide spread around the mean - all of which the government tried to suppress by administrative measures. Thus on the intermediation side the banks' growing risk aversion, combined with oligopolistically contrived scarcities on the rationed credits, led to an even tighter monetary squeeze and corruption. The latter can be explained as a natural rationing device, once there is a gap between the regulated lending interest rate and its higher potential market level.

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

g) Labour market. The 3.5 % average unemployment rate in December 1993, with the average unemployment duration of 4.3 months in 1993, means practically full employment. The extensive employment restructuring was proceeding inconspicuously, yet quite intensively. The frictional and structural unemployment caused by this process was solved locally in the majority of cases. Even in the worst hit regions of Moravia the results are lower than the natural rate of unemployment, which, for the economies in transition, can be estimated to be between 5 and 8 %. This success is mainly due to state corporate debt relief schemes, reluctance of banks to bring their corporate creditors to bankruptcy and efficient employment schemes (e.g. a subsidy of up to 50,000 Kč for companies hiring unemployed persons in certain

districts). The private sector was thus able to absorb quite quickly and smoothly the departures and the layoffs from the corporate (mainly manufacturing) sector in 1990-93. With the officially recorded labor mobility over 1.5 million workers only in 1990-92 (see MPSV (1993)) out of the initial full employment of 5.3 million in 1989, the real mobility (including the transfers inside the corporate sector) for 1990-93 could affect over 40 % of the labor force. At least 1.7 mil. jobs were created in the booming SMEs during the first four years of transition.

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

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

As can be seen, the recent Czech economic policy instruments had numerous impacts on the business sector, some of these quite delicately chosen both in time and sequence, some seeming random, and some void of any pre-conceived positive aim. As far as the promotion of entrepreneurship in small businesses is concerned, we can hardly speak about the existence of an extensive systematic policy. Even though it is generally agreed that the government should be involved in such policies, it still remains uncertain if the government has at its disposal reliable and efficient instruments for full-fledged control of this task. It was not long ago that very few economic textbooks were concerned with this question. In the best cases, it was tacitly understood that entry into business and the accumulation of capital required simply time and patience. In the worst cases, it was said that the only ways to get started were by parsimony, patrimony and matrimony. Without doubt, we cannot expect a miraculous change to enter this scene.

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

4. Privatization and Entrepreneurship

The privatization schemes, along with the availability of financial capital, are crucial conditions for the free rise of entrepreneurship. Czechoslovak privatization was marked by class orientation, as it was divided into so called "small" and "large" privatization schemes. Due to

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

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

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

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

- * Privatization opportunities were more favorable to two narrow and privileged groups of the society who evolved from the institutional idiosyncrasies of the communist past;
- * In 1990-93 it still remained significantly easier to accumulate physical capital through redistribution and bargaining with bureaucracy than through productive entrepreneurial activity;
- * The newly emerging class of capital owners may not be strongly correlated with entrepreneurial and managerial skills (and vice versa). A long-lasting secondary round of ownership changes should be expected before the process of effective privatization finally calms down;
- * Since the skills for acquiring property through redistribution (privatization) may not always be complemented with the skills for managing its production and because of

extensive restitutions, there are developing conditions allowing the rise of the rentier class of owners.

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

According to an extensive sociological survey done at the Czech Academy of Science (Vítečková (1993)), the structure of Czech private entrepreneurs in December 1992 showed some interesting properties. The study was limited to a widely distributed sample of 1000 businessmen, tradesmen and artisans each of whom had registered as a firm with legal status and hired a staff of employees. It is important to mention that it excluded persons licensed to self-employed proprietorship. While the latter numbered over 1 million licensees in 1992 (out of the full-time Czech employment of 4.8 million), the number of registered private firms with legal status did not exceed 70,000. Thus the number of Czech "big entrepreneurs" with capitalistic businesses of their own, selected from the set of the existing one and a quarter of a million people with entrepreneurial aspirations, could be estimated to an orientational number of approximately 120,000.

Caveat emptor: evidently, this intuitive approach (as do some other estimates in this paragraph) does not represent an unimpeachable scientific method in making generalizations about reality. Unfortunately, the data allowing more objective and verifiable statements has not been available for this problem. Perhaps we can argue that the intuitive estimates made here about such sensitive matters like ethical classifications, are no more biased than the notoriously subjective personal confessions required in questionnaire surveys. Our results characterizing the origin and mobility of Czech entrepreneurs are summed up in Table 3. Column A shows the estimated breakdown of total Czech employment in 1989 by managerial ranks (stylized facts intuitive estimate). Column B shows the structure of entrepreneurs (according to the findings of Vítečková (1993)), who established business firms with legal status **in 1990-92**, classified and ranked according to their highest working assignments achieved anytime during their careers **before 1990**.

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

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

If these estimates are correct and reflect at least the basic structure of the past

management and the present private entrepreneurship, then the following implications can be drawn:

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

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

None of the above statements about the nomenklatura are meant as value judgments. What is of importance is their descriptive implications. The error of many Western observers of transition rests in the tacit assumption that the Eastern totalitarian society was completely void of any entrepreneurship, organizational spirit and rationality. Thus all of these qualities, as erroneously expected, have to be imported and introduced from abroad. The philosophy of the early approaches of the West to German unification still has its heirs. The most assertive conclusion of that sort is the absurd recommendation to make the imports of entrepreneurial know-how exclusively from the more dynamic Far East. On the contrary, it can be found that successful entrepreneurship is often closely linked with domestic management, domestic traditions and domestic resources - a fact that is often disregarded even by the local insiders. Then also the local nomenklatura must have its place in the process.

c) In the better case it should be admitted that in the last 20 years of its rule the CP developed an extremely enlightened and far-sighted personnel policy. (However, very few observers among the dissidents would have come to this surprising conclusion prior to 1990!) In the worst case we can see an updated version of Orwell's Animal Farm. The true evaluation lies somewhere in between. On one hand, it must be admitted that one of the main reasons for the collapse of communism was that it failed to offer the vast majority of people a free opportunity to fulfil their ambitions and instead nurtured just a thin, privileged elite organized in the upper levels of the party hierarchy. On the other hand, it required from them some degree of animal spirit and leadership, which have now proved to be viable skills in all circumstances. This would fully fit Baumol's

(1990) theory that entrepreneurship and its aim of profit or power is omnipresent in all societies. **The problem is in which alternative economic fields (productive, unproductive or destructive), and under what conditions and incentives, the entrepreneurship is allocated in the given period.**

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

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

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

There have recently been some other quantitative empirical studies concentrating on the topic of classification, origin and success of the new Czech entrepreneurs. Matějů

(1993a) comes to the conclusion that being a member of the nomenklatura results in "far higher chances to enter the group of entrepreneurs" (p. 86), mainly due to the role of various social assets (e.g. the ability to mobilize informal contacts) which had been accumulated in the past career. In another study (Matějů (1993b)), aimed at explaining

of them deserve a chance. It is a well known fact that the barriers to entry are rising as the transition is proceeding.

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

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

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

A) Registration and Licensing for Entry.

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

B) Availability of capital

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

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

Thus, in their search for capital, the majority of future Czech entrepreneurs had to rely on the financial market, primarily on the availability of bank credits. This situation is significantly different from that in developed market economies where the retained profits and depreciation provide 55 - 75 % of total investment resources. After three years of unparalleled boost, in 1993 the Czech banking sector reached a considerable size, density and scope of activities. Nevertheless, its efficiency was still low and its functioning was subject to market imperfections. Real interest on savings (the nominal rate was 2-12 %) was generally negative and the nominal interest rate on loans (15-20%) still did not clear the market. The banks, like skilled profit maximizing oligopolists, were limiting the supply of their services by universally refusing to finance "risky ventures", i.e. those without at least 100% mortgage or other secure collateral available. Hence, as confidential personal communication widely disclosed, the entrepreneurs with highly promising projects but with no property for collateral (e.g. for investing in inventories or paying for the lease of premises) were regularly refused credit, if a sufficient bribe (2-5% of the loan) was not paid. It has even become a routine to require a 2% bribe for credits hedged by a mortgage - a rather unorthodox interpretation of both market clearing and corporate governance in privatized banks. It is the bribe which blurs the distinction between a loan for a serious investment project and a non-performing loan purposefully acquired for capital stripping and subsequent suicidal bankruptcy. Even though the latter type of non-performing credits have been on the decrease since 1993 (there were estimates that they formed up to 30 % of loans in 1991-92 and the estimates for 1993 are 10-15%), their role in spoiling financial market ethics is substantial.

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

C. Acquiring Working Premises

Once the entrepreneur succeeded in securing the financial resources, the next stage would be acquiring the working premises, a process also subject to official approval. But before applying for it, the future entrepreneur must be sure he has contracted some premises for his disposal. He may be saved a lot of problems if he receives a real estate restitution or if he intends to run the business from his house or apartment. Otherwise he must enter the real estate market and lease (very often just for one year only) or purchase the property. The private property market very quickly became quite competitive and efficient. The problem is, however, that its prices follow the housing scarcities and rent in some towns can reach \$50-\$700 per square meter per year. The payment must often be disbursed before the premises are approved by the district council.

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

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

D. Getting Approval for Running the Premises

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

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

E) Hiring Working Staff

The travails of the entrepreneurs are not over once the business has been given permission to open. One of the most damaging legacies of the communist past is the devastation of the workers' morale. The continuing very low level of unemployment in the Czech Republic, sustained by the government's extremely cautious bankruptcy policy (see Hlaváček, Tůma (1993)) and numerous schemes for resuscitating the indebted corporations, are not pressing for a change in the working discipline. The average unemployment rate of 3.5% in December 1993, for a country in intensive transition, equals practically full employment. The sixty-four bankruptcies executed until the end of 1993 (out of 1448 proposals delivered to the courts - as disclosed by the Ministry for Economy in March 1994) and the closing down of approximately forty minor inefficient state companies in 1992 was like waiting for the *deus ex machina*.

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

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

C o u n t r y	Private firms	State firms	International firms
Czech Lands, monthly	4728 Kčs	4813 Kčs	5653 Kčs

Slovakia, monthly	3949 Kčs	4565 Kčs	4975 Kčs
Czech Lands, per year	2025 USD	2062 USD	2423 USD
Slovakia, per year	1692 USD	1956 USD	2132 USD

Source: Statistické přehledy, ČSÚ, Prague, č. 3/1993, p. 79

Remark: 36% of health and social security insurance (the part paid by the employer) should be added to the above figures. Firms often provide hidden fringes to supplement the wages. Relative to the figures in this table, wages increased by approximately 40% by the end of 1993.

The bilking of the employer and the customers (the latter up to the level of their consumer surplus) is quite frustrating. The firing of an employee and the hiring of a substitute is often a long-lasting and very costly process due to high transaction costs. So the entrepreneur and his family are often the only people who can bear the weight of small private businesses. Competition and the vision of future opportunities drives them to 12-18 hour shifts with no weekends. This is especially typical for those entrepreneurs who formerly did not belong to the privileged classes, who started from scratch and who are trying to earn their own capital for the next real start or to repay a loan.

F) Running the Daily Business Routines

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

As discipline of suppliers was significantly consolidated in 1992, much lower stocks were necessary to secure the regular flow of business. The problem of the credibility of inter-firm payment discipline still remained critical. Some firms refused to accept anything but cash, even for large contracts. The processing of a bank transfer can take up to a month, thus some firms cannot honor their debts because of short-term liquidity problems. Banks are reluctant to engage in short-term credit services. There is also a high risk of the customer's long-term default in payments because some firms take these

as an opportunity to raise their capital. Inter-firm indebtedness in 1993 was estimated to be around 160 bil. Kč (see also Charap, Zemplerová (1993), Hlaváček, Tůma (1993) or Hrnčíř (1993)). Legal action against payment defaults is not a credible threat because the whole state judiciary system is in crisis. Getting a law suit started in six months is a heroic undertaking.

The price which Eastern Europe must pay for its capitalist resurrection is an increased intensity of work, a rise in general uncertainty and the proliferation of crime. While the first two are natural and revitalizing necessary conditions, the last one is a mere collective failure. The total number of investigated crimes in Czechoslovakia has increased from 94,000 in 1989 to 295,000 in 1992 (see *Hospodářské noviny*, 23.6.1993, p.8, quoting statistics of the Public Prosecutor). Of this number, crimes against property rights (mainly covering theft) increased from 23,500 in 1989 (30.4% solved) to 327,000 in 1993 (21% solved). However, the number of "other economic crimes" fell from 20,444 in 1989 to 1788 in 1992. These include tax evasion (18 investigated cases in 1991 and only mildly more in 1992), crimes against business competition, fraud, insider trading and corruption. It is not that these types of crime have been falling recently, but simply that they have become less transparent and increasingly difficult to investigate in the new legal environment. Some reasons for these difficulties are:

- * A lack of functioning institutions representing the state or corporate owner and systematically inquiring into the causes of crime;
- * The respective laws (e.g. financial, commercial, anti-trust) are new and complicated, have many loopholes and there is a shortage of experts to initiate the prosecution;
- * The police and the judiciary are under severe pressure to solve "more pressing" (i.e. less complicated) daily problems and there is a shortage of qualified lawyers for the investigation.

The failure of the judiciary is accompanied by offers from organized crime to hire the services of a professional racketeer to have the case of debt or rivalry efficiently cleared. Blackmailing and payment of "protection" money is another expanding new trend which, until now, has been difficult to cope with.

It is recommended to avoid any contact with public institutions because, for example, it is an endless headache to bring the idea of displaying a signpost or advertisement on public property without bribing the public architect and the licensing institution. The attempts to get an approval of some special (legally supported) scheme concerning investment or tax policy reliefs are often met with administrative obstacles and intransparency of the whole procedure.

G. Financial Links with the State

There are two positive idiosyncrasies characteristic of traditional Czech society: to abide by fiscal obligations and to save. It came as a surprise that the Budget revenues from the ill-prepared new VAT scheme of 1993 surpassed all expectations. This scheme, introducing a 5% tax on food and a 23% tax on the majority of remaining products, became a nightmare for small entrepreneurs. The law was very complicated, amended

several times and badly advertised. The help offered to SMEs by the tax exemption option proved later to be a disadvantage, disorganizing the pricing procedures and creating the need to search for a (very scarce) professional accountant.

The level of taxation in the Czech Republic is high even by some West European socialist standards. The sceptics argue by using Murphy's Law that once the taxes are introduced they are never lowered and can become only higher. An income (profit) tax of 45%, with practically no tax relief for the heavily investing or the newly starting businesses, is a heavy disincentive to run one's own business. Many small firms are tempted to manipulate the costs (e.g. on expensive furniture, electronics, cars or travels) in order to reach a "fair" level of taxation (Charap (1993)). Another serious burden is the compulsory 49.5% social and health insurance levied from 1993 on the gross payrolls (of which 36% is paid by the employer). In addition to the 13.5% insurance contribution by the employee, personal income tax must be also paid, so that the individual's net income in its upper brackets is 47% lower than the labor cost paid to him/her by the employer. For example, the average gross wage in industry in December 1993 was 6923 Kč per month, representing a 24% increase in one year. If the 36% insurance is added, the resulting labor payment becomes 9415 Kč (\$330) per month - considerably more than what Table 4 (above) might indicate.

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

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

7. C o n c l u s i o n s

The Czech private sector, small and medium businesses and their entrepreneurship, expanded with unprecedented speed between 1990-93. Even though the official estimates

confirm their booming development, a significant part of private activities have not been recorded and have thus escaped statistics. A cautious estimate may be made that the share of the effective private sector (the corporate sector excluded) on GDP may have already reached approximately 35-40%, far more than the official estimate of 26-30 % for 1993.

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

A distinction should be made between the government-devised conditions for the redistribution of wealth (i.e. privatization) and the conditions for the creation of wealth (i.e. running the business). While the former received wide attention, the latter remained to a large extent underdeveloped and neglected, especially in the field of the promotion of new small businesses.

The following **policy recommendations** can be drawn from the paper:

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

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

*3. The policies prevailing in the initial stage of transition should in many aspects be reversed or supplemented with new relevant measures. While the existing policies

were oriented predominantly on the transformation of big businesses, the processes of redistribution, the provision of standard marketable goods, the restructuring of the old networks of economic power, the reorganization of the old bureaucracy and the graceful dismantling of the existing industrial patterns, the new policies should be oriented towards the development of small and medium sized businesses, the creation of new productive units, the provision of public goods and the steady rise of opportunities for the new entrepreneurship, investments and innovations.

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

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

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

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

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

*9. The industrial policy schemes for the promotion of new and small businesses

should be significantly expanded, mainly in the fields of credit availability and promotion of investment. The promotion of virtually absent alternative financial facilities, such as venture capital business, development banking, municipal banks, credit unions and non-profit credit cooperatives, should be supported.

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

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