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The role of the new entrepreneurial private sector in transition and economic performance in light of the successes in Poland, the Czech Republic and Hungary

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Contents

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Jan Winiecki

The role of the new, entrepreneurial private sector in transition and economic performance in light of the successes in Poland, the Czech Republic and Hungary

Abstract

The central theme of this paper is the role of the new, entrepreneurial private sector, established after the fall of communism, in output recovery, and, more generally, in economic expansion of post-communist economies. This role is considered specifically in the context of the successes in Poland, the Czech Republic, and Hungary. The author notes a substantial difference between the performance of the new private sector and the privatized sector in the short to medium run (3-7 years) from the start of privatization.

New private firms typically enter the economic game with well-established *de jure* and *de facto* property rights and with industrial relations based on market economy rules. Unlike the public sector or privatized firms, the labor force of these firms is not demoralized by the change to market-economy rules. As a result, they often perform better and are quick to increasing their share of aggregate output. This also helps the economy as a whole emerge earlier from transitional recession.

The author discusses two hypothetical paths of recovery and expansion; one with and one without a dynamic new private sector. The determinants for establishing and growth of new private firms are considered. In addition to the specific rules and general framework of transition, the study concludes that broad institutional fundamentals of political liberty, law and order, and trust contribute to the successful emergence of this new entrepreneurial sector.

Key words: new private sector, transition, growth, Poland

1 Introduction

The following analysis tackles an issue largely neglected in the transition literature – the relative weights of the new, entrepreneurial private sector and the privatized sector in the aggregate private sector during transition. The internal composition of the private sector apparently has a strong influence on economic performance, particularly in the short to medium term (three to seven years from the start of systemic change).[1] A thriving sector of *de novo* private firms seems to shorten the time of transformational recession lasts and add to the strength of subsequent recovery, so we also examine the causes of the relatively poor performance of privatized firms.

The study begins with an examination of traditional economic, social, and political influences on the health of the small and middle-sized firms with special attention to issues of post-communist transition. Next, we outline two hypothetical, or "stylized," output paths of transition. Both rapid, strong recovery and slow, weak recovery are shown to depend on the dynamics of the new private sector.

Finally, we consider the determinants of the dynamics of *de novo* private firms. The operating environment for such firms is determined at three levels: detailed rules that more strongly affect smaller firms, the general framework, or "Holy Trinity," of progress in transition (stabilization, liberalization, privatization), and the broadest framework of liberty, law and order, and trust. The paper ends with discussion of the post-communist economic realities facing the Czech Republic, Hungary, and Poland.

2 Post-communist transition and importance of the generic private sector

Before focusing on the new, entrepreneurial, private sector in economies in transition, we must first ask what characterizes a new (*de novo*) firm. One statistical approach to identifying new firms is to equate the generic private sector with the sector of small and medium-sized enterprises (SMEs). While it is logical to assume new firms start small, we should expect statistical

[1] The terms transition, transformation, and systemic change are treated here as substitutes.

discrepancies between these sets of firms (new and SMEs). Post-communist economies in particular saw new firms created through the privatization of large state enterprises and spin-offs from large state firms.

Still, there are compelling reasons to use SMEs. In developed Western economies, for example, SMEs, excluding agriculture, generate between one-third and two-thirds of GDP and between one-half and three-quarters of aggregate employment. They are the engines of economic activity. Table 1 presents data for a number of both large and small OECD countries, as well as for the three countries under study.

Table 1. Percentage share of SMEs in aggregate employment of select OECD countries circa 1996

Country	**Share, percentage of total**
Portugal	80.0
Spain	79.8
Switzerland	69.9
Denmark	68.7
Ireland	68.4
France	63.2
Netherlands	60.7
Sweden	60.3 *a*
Germany	59.7
Canada	38.4 *b*
USA	37.7 *b*
Memorandum item	
Hungary	70.1
Poland	63.2
Czech Republic	52.3

Note: SMEs employing up to 249 persons, except where indicated.
a = SMEs with up to 199 employees
b = SMEs with up to 100 employees.

Sources: OECD Small and Medium Enterprise Outlook, 2000, and State of Small and Medium Sized Business in Hungary, 1999.

Small and middle-sized firms are intimately linked to entrepreneurship. Entrepreneurs, i.e. manufacturers, merchants, craftsmen, other providers of numerous services, have historically formed the backbone of the middle class, and the middle class, in turn, has been the mainstay of the liberty-based republican order.

Indeed, entrepreneurs have long been perceived as the upholders of hard work, prudence, thrift, self-reliance, and (as referred to in Victorian times) "lesser virtues," upon which the capitalist market order and its unparalleled prosperity has been built. Pointing to entrepreneurial and civic initiatives of Americans, Alexis de Tocqueville noted in his classic study, "What most astonished me in the United States is not so much the marvelous grandeur of some undertakings as the innumerable multitude of small ones." (*Democracy in America*, vol. 2, 1840).

These traditional interests in the role of the entrepreneurial private sector alone should justify interest in that sector in emerging post-communist market economies. In the case of countries making the transition from centrally administered economies to capitalist market order, however, several additional factors further compel study.

First, transition countries had to reestablish (or establish from scratch) structures of ownership based on a preponderance of privately held firms. As I noted a decade ago (Gruszecki and Winiecki, 1991; Winiecki, 1992), changes in the structure of ownership in the national economy are accomplished in two ways, and not, as commonly held, simply through transforming state-owned firms (SOEs) to privately owned firms.

Transforming SOEs into privately owned firms is only part of the process of privatization of a national economy. It might be more correctly dubbed "privatization-from-above" as it entails state activism. The other aspect of privatization is the expansion of the generic private sector through creation of *de novo* firms. Here, the state only provides enabling conditions. We might call this approach "privatization-from-below."

In Poland's case (and indeed, throughout the post-communist world), privatization-from-above has long dominated public debate and policy-making. In a country report on Poland, for example, I tracked discussion of the transition program presented by the first Polish non-communist government

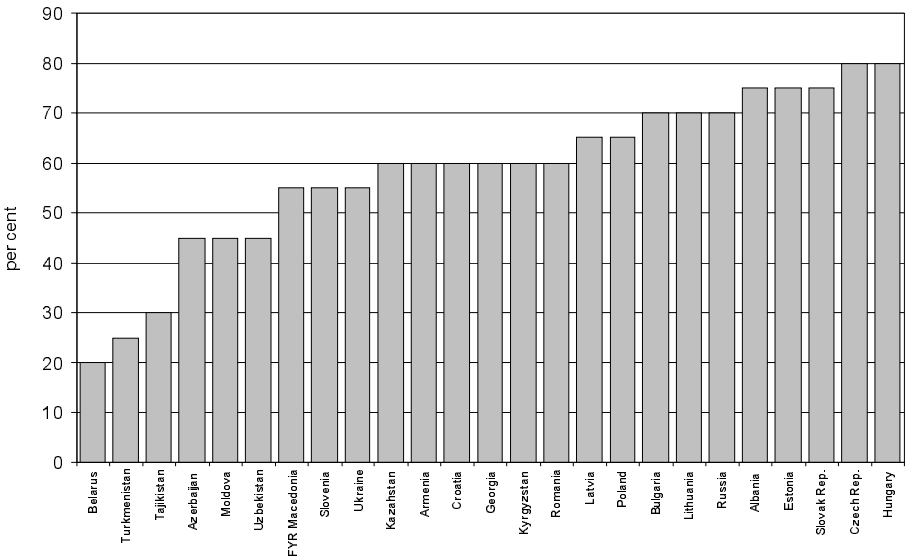
in October 1989. Out of eight tabloid-size newspaper pages of discussion devoted to the transition measures, only *half a sentence* discussed establishing an entrepreneurial sector. This sentence occurred in a discussion of the need to establish proper competitive conditions and "*full freedom in establishing new* (presumably private) *firms*" (Program Gospodarczy, 1989, p.4). All other discussion adhered closely to the "Holy Trinity" of transition from above: stabilization, liberalization, and privatization.

While students of transition, particularly those acknowledging the role of the privatization-from-below, have been strongly critical of this peculiar bias (e.g. Benacek, 2001), this bias is easy to understand. At the time of the collapse of the communist system, the public sector (or as it was then called, the "socialized" sector) accounted for 80% to 100% of aggregate output and employed similar shares of the labor force.

Few of those analysts paid attention to the earlier works of Anne Krueger (Krueger, 1983 and 1984), which stressed the experience of liberalizing developing countries (LDCs). In successful transition countries ten years after the start of liberalization, she and, her collaborators, found that about half of all employment was registered with the firms that had not existed a decade earlier.

What is striking today is that scholars still overlook this remarkable feature of currently successful transition economies. Perhaps it is because politicians, trade unionists, pundits, and employees all tied their hope of a successful systemic change to the transformation of state-owned enterprises. Nevertheless, "from above" and "from below" forms of privatization both clearly contributed to the emergence of these private sectors. Figure 1 approximates the aggregate shares of the private sector in GDP in 1999 in national economies. In successful transition countries, this share typically exceeds 60%. In Hungary and the Czech Republic, it approaches 80%. The outlier is Slovenia, with its share of the private sector slightly below 55%. It should be noted that a number of countries less successful transitions, including Albania, Russia, Romania, and Bulgaria also have high aggregate private sector shares. Apparently, a high aggregate share of the private sector by itself is insufficient for determining the outcome of the transition process.

Figure 1. Aggregate private sector shares



Source: Transition Report 2000, EBRD

Secondly, it was not just ownership, but the *size structure* of the capitalist market economy that had to be reestablished during the transition process. The distorted size structure, one of many harmful legacies of the communist past, was heavily skewed in favor of large firms. It had to undergo radical change to reestablish (or, again, for countries that did not reach the capitalist market economy stage before communism, to establish) a normally functioning network of small, middle-sized, and large firms cooperating with each other as suppliers and consumers of goods and services.

SMEs historically not only produce and trade in final goods, but also supply inputs to large firms. Given their flexibility and entrepreneurial initiative they have been far more efficient in these roles than large firms.

Table 2 presents the share of SMEs in aggregate output in manufacturing in select Western countries, including the three transition countries under study. As seen in Table 1, these three countries reestablished their market economy size structure, and today differ little from other Western countries.

Table 2. Share of SMEs in manufacturing output in select OECD countries in the late 1990s

Country	Share as percentage of total
Italy	54.8
Greece	54.1
Portugal	53.3 *a*
Austria	44.0
Japan	43.0 *a*
Belgium	40.6 *a*
Turkey	39.7
United Kingdom	36.9
Sweden	35.8
Finland	30.2
USA	14.3 *b*
Memorandum item	
Poland	38.1 *c*
Czech Republic	37.5
Hungary	36.7

Note: Output in firms employing up to 249 persons, except where indicated.
a = Output of firms employing up to 199 persons.
b = Output of firms employing up to 99 persons.
c = Industrial output (mining, manufacturing, and utilities).

Sources: OECD Small and Medium Enterprises Outlook, 2000; State of Small and Medium Sized Business in Hungary, 1999; and Winiecki, 2001.

Again, the shares of the entrepreneurial firms in aggregate output and employment do not completely reflect the extent of progress in the catching-up process. In addition to the proportion of small and middle-sized firms, their *density* matters. SME density can be described in terms of number per thousand of population, per unit (say, billion dollars) of GDP, or some similar indicator. They all indicate whether the network of firms is sufficiently dense to undertake new tasks of supplying large old firms or modernizing their

production profile. Interestingly, such indicators are fairly rudimentary, despite the enormous amount of empirical research on transition. The rare exceptions (e.g. Benacek and Zemplinerova, 1994, Zemplinerova, 1997) conclude that successful transition economies converge with the average density of SMEs in Western Europe.

The third factor worth study is the special relationship between the generic, entrepreneurial sector and the privatized sector in determining of economic performance (see Winiecki, 1996, 1999, and 2000a). The phenomenal growth of the Polish economy in the first decade of transition, as well as its early recovery from transformational recession (to use the terminology of Kornai, 1994), was, in my opinion, largely driven by the make-up of the private sector. Specifically, the high share of the generic private sector compared to privatized SOEs.

My thesis (developed in Winiecki, 1999 and 2000a) is that different types of private firms behave differently in the first three to seven years of transition. In *de novo* generic private firms, the structure of ownership and relations between owners and management (when they are not the same person) reflect the requirements of the capitalist market economy. Industrial relations between the management and employees are based on the understanding and acceptance of market rules. Old-regime working habits are not transmitted *en masse* to such new firms, and they react swiftly and effectively to individual cases of sloppy workmanship and other transgressions common in the early years of *de novo* firms with retraining, sanctions, or dismissal.

The behavioral patterns in privatized SOEs, on the other hand, tolerate, at least temporarily, the survival of old patterns inherited from communist times. Since nearly everything remains outwardly the same, except, may be, for the behavior of a few expatriate managers brought in by a new owner (if there is one!), leisure on the job, shirking and other features characteristic of SOEs under the communist system disappear slowly. Workers, who must adapt quickly to the new requirements of *de novo* firms, are often allowed to keep their old habits in privatized SOEs. These habits are reinforced by their observation of others workers.

The period of adjustment, of instilling new (or old, but long-forgotten) work ethics, lasts a while even in SOEs taken over by a strategic investor. The story is obviously worse for SOEs privatized without a strategic owner.

The foregoing is well supported empirically. Havrylyshyn and McGettigan (1999) surveyed much of the theoretical and empirical literature on privatization, distilling efficiency rankings for firms operating in transition economies. Across the board, generic, *de novo*, private firms perform best. SOEs perform worse than privatized firms, and insider-owned privatized firms perform worse than other privatized firms. Other country studies affirm this pattern (for Poland see Pinto *et al.*, 1993, and Jarosz, 2000; for Slovenia see Simoneti *et al.*, 2000).

Poland's case has been one of the rapid privatization-from-below and slow privatization-from-above (Winiecki, 2000a). This approach is unique among post-communist economies in transition. That said, it appears that a significant share of new private firms in the aggregate output of the private sector seem to positively affect the dynamism of *any* transition economy. The other two economies under study, the Czech Republic and Hungary, also registered relatively strong expansions of their entrepreneurial new private sectors (contributing 25 to 40% of GDP by the end of the first decade of transition).

We now systematically consider the linkages between the presence of a large generic private sector and economic performance. Of the three special, transition-related factors noted above, we concentrate on the last in discerning linkages between the new entrepreneurial private sector and economic dynamism.

3 Alternative paths of recession, recovery and expansion

Scholarly interest in the dynamics of the new private sector is recent (e.g. De Broek and Koen, 2001). We infer that the contribution of the new private sector is most significant in the short-to-medium run, as the above-noted performance differences between new private firms and privatized firms tend to subside over time. Workers and old-regime managers must eventually

adjust to the performance requirements of capitalist firms, whether they like it or not, or face the discipline of the market. Moreover, the process of adjustment is likely to be faster in firms acquired by foreign strategic investors that provide expatriate managers, extensive training in-country and abroad, and other inputs. In the worst case, old-regime holdouts (unsuccessfully privatized firms) must simply exit the market.

Within three to seven years from the start of transition, the behaviors of different types of private firms and their industrial relations grow similar as the consequences for performance become the same for all and the relative size of new private sector and privatized sector cease to matter.

At the start of transition, however, these differences are pronounced – and possibly decisive in the success of a nation's transition process. To determine output effects, we present two hypothetical, or stylized, output paths for post-communist transition. The first path describes economies with a large, dynamic new private sector. The second path presents economies where the importance of the generic private sector is small or marginal. These stylized cases deliberately over-emphasize differences for expository purposes to create distinctly contrasting paths. The real-life patterns of post-communist transition are obviously more nuanced.

The two paths are presented in Figures 2A and 2B. The stylized economy with the fast growing and increasingly large new private sector in Figure 2A registers output falling sharply at the start of transition, when old demand (reflecting distorted incentives under the communist system) shrinks dramatically and state-owned enterprises face new demand. Consequently, firms slash inventories, cut investment, and try (generally without success) to adjust to market demands (Winiecki 2000b and 2002 forthcoming).

The new private sector may be built from scratch as in the Czech Republic, or ramped up from insignificance as in Poland and Hungary. Within two to three years, the new private sector reaches critical mass, i.e. becomes large enough to influence aggregate output. Thereafter, it exerts an increasing significance on the path of aggregate output.

Figure 2a. Stylized alternative output paths in transition: Output path with a large new private sector.

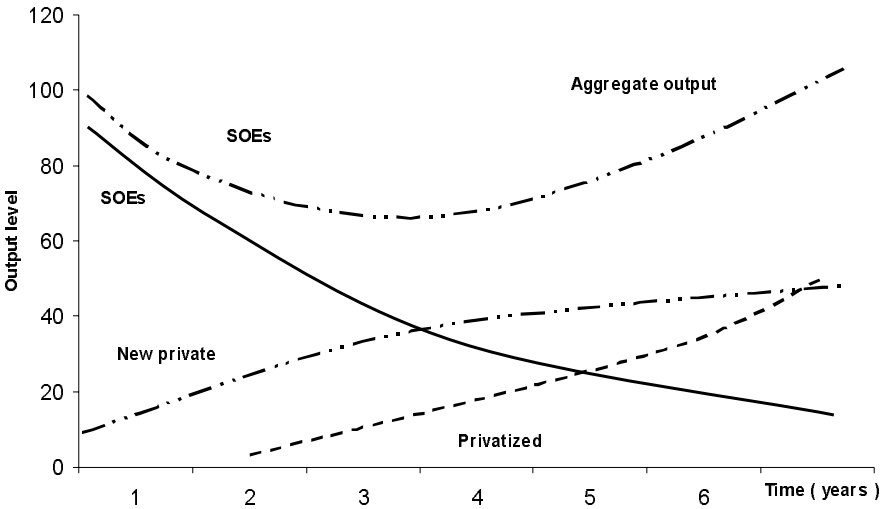
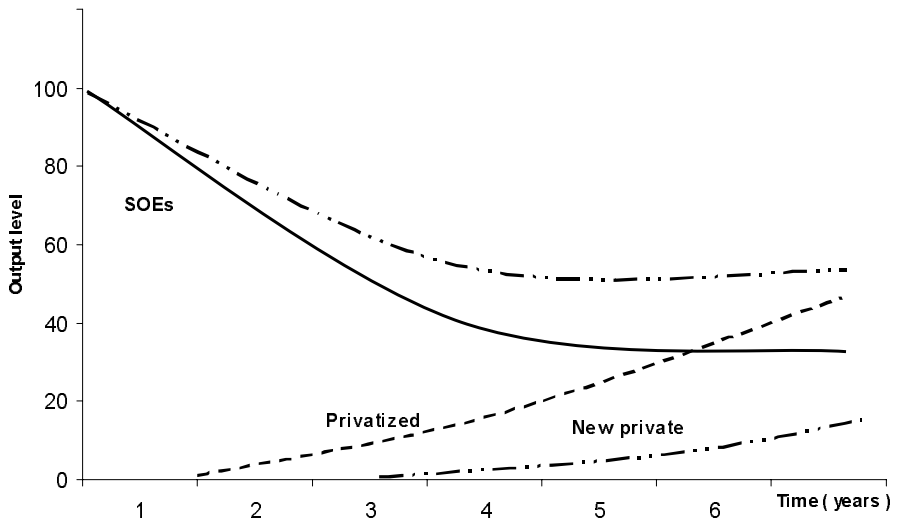


Figure 2b. Stylized alternative output paths in transition: Output path with a small new private sector.



Meanwhile, output and employment fall in the state enterprise sector (in Poland, for example, this shrinking ended in the fifth year of transition). The new entrepreneurial private sector eventually begins to contribute more to output than state enterprise sector detracts in value terms. Thus, aggregate output levels off and starts to rise. Both paths are shown in parallel with the aggregate output path, whereby the transformational recession ends and recovery begins. While the adjustment of SOEs and privatized SOEs continues, it no longer reduces aggregate output.

We can see that over time the privatized sector begins to contribute to aggregate output, while the SOE sector shrinks. This fall is due to the continuing fall of output *per* enterprise and the shift of enterprises from the state enterprise sector to the privatized sector. With both components of the private sector – new private and privatized – adding to output, recovery turns into expansion. Job creation takes place almost exclusively in the new private sector.

We also see that early recovery in the third and fourth years of transition is completely dependent on the dynamics of the new private sector. The SOE sector is still shrinking and the privatized sector is still insignificant.

Figure 2B shows a second stylized output path, where, due to yet-unspecified barriers, the new private sector fails to contribute to output and employment.

The SOE sector faces the constraint of a disappearing distorted demand from the communist past and, as a result, cuts output. We assume a *rough* similarity with the falling output of SOEs in successful transition economies, whereby the new generic private sector expands rapidly. Most successful transition countries liberalize drastically, while simultaneously attempting to stabilize their economies. Consequently, the fall of demand on the side of the partly adjusting producers and fully adjusting consumers is steeper.

In this second case, both liberalization and stabilization measures are less decisive and less extensive. No watershed point – the decisive break with the past – is imprinted in the minds of economic agents. Adjustment steps are hesitant and less coherent. Past patterns of behavior exert stronger pressure on decision processes than in the case of economic agents in the successful transition countries. As a result, output adjustment is less than in the first case.

Privatization-from-above can proceed slowly or rapidly. In either case, the contribution to output of the privatized sector is next to zero in the short run. In the case of rapid privatization-from-above, it begins to be substantial in the medium run (at the expense of a faster fall in the share of the SOE sector).

Neither process, however, can reverse the path of falling output in the short-to-medium run. Aggregate output may fall more slowly than in the case described in Figure 2B but continues much longer than in successful transition economies.

The SOE sector's output declines steeply in both cases, due first to adjustment to market demand (or non-adjustment and exit), and in the medium run to the shift of firms from the SOE sector to the privatized sector. There is only slight increase in output and none in employment (which adjusts slowly in general and even more slowly in unsuccessful countries). Thus, increase in output and employment has to come from slow-growing new private sector.

The slow-growing entrepreneurial sector does not generate enough output and employment to match the continuing losses of the state enterprise sector and the privatized sector. The aggregate output path in Figure 2B reflects this by showing continuing decline over both the short and medium term. The decisive role of the new private sector for the recovery and expansion of output during the first three to seven years of transition is clearly presented in the above alternative output paths.

Old state enterprises, privatized or not, are unwilling or unable by themselves to adjust fully to the new requirements of the market. They are also oblivious to the competitive pressure of the multitude of new private firms that should force them to make greater adjustment efforts. Instead, they continue to cut output and, with a lag, to downsize, tending toward the low-level equilibrium at the enterprise and – in the absence of the new private sector – at the national economy level as well.

Any recovery is modest in this case. Output of the combined state and privatized sector stops declining and edges upward, getting little or no boost from the new private sector. Expansion, understood here as a robust GDP growth sustained over several years, never occurs. The return to the output

level of the pre-transition period (whatever that means in real terms, given the distorted communist-era statistics (Winiecki 1991a) is not attained, nor does it look attainable even in the longer run.

4 Three levels of performance explanations of the new entrepreneurial sector

4.1 Preliminary Systematization

In the preceding section, we discussed stylized paths of recession, recovery and expansion of a post-communist transition, and relative performances of the new, entrepreneurial private sector. We now consider (to paraphrase Adam Smith) the success and failure of nations in creating enabling conditions for the establishment and expansion of *de novo* private firms.

A caveat is in order. Enabling conditions may exist or be introduced through regulations and policies with differing proximity to economic agents. The impact of rules and policies, or economic developments may be immediate and *directly* affect a particular class of economic agents (often in a manner different from effects on other economic agents), or general policies may affect all economic agents *indirectly* (e.g. tighter monetary policy that increases borrowing costs). In terms of post-communist transition, this reflects the difference between the impact of the detailed regulatory framework and administrative decisions on activities of new and expanding entrepreneurial firms and the impact on the same category of firms in the changing framework of stabilization, liberalization, and privatization.

There is also an even broader level of influence. The systemic level touches fundamental aspects of the political, economic, and social system. Thus, the conditions conducive for the establishment and expansion of the new private sector appear at three levels:

- Low level – comprising detailed rules, and policies pursued within rules;
- Intermediate level – comprising the framework of stabilization, liberalization, and privatization; and

- High level – the sphere of evolving political, economic, and societal fundamentals.

We suggest further that the degree of influence increases with each level.

4.2 Detailed Rules, Policies, and Developments Affecting the New Private Sector

These levels of rules and policies may be further broken down into rules and policies affecting establishment and those affecting operations. As to establishment, entry rules are the first hurdle a nascent firm must overcome on the road to survival and growth. Thus, rules of establishment merit serious scrutiny. The simplicity, transparency, and parsimony of the required procedures for establishment, the speed of operation of the organizations involved in screening procedures, and the cost of going through the process of establishment all matter.

Djankov *et al.* (2000) made a large-scale, detailed study of the regulation of entry, covering 75 countries. As the study covers most transition countries, it provides an opportunity to look at transition economies from a comparative perspective. We can compare transition economies with each other and with mature market economies.

Before trying to make sense of the numbers, a word on the debate on the origins of regulation is in order. As stressed in the theoretical part of the Djankov study, there are alternative theories of regulation found in the literature. Traditional neoclassical (Pigouvian) theory holds that regulations are imposed to correct market failures. The extensive governmental (or government-mandated) screening is aimed at making sure that demanders receive the product or service of the required quality from properly screened suppliers. By Pigouvian standards, then, increased regulation correlates with socially superior outcomes.

Theories that view regulation from the perspective of public choice (rent-seeking) argue regulations are imposed primarily to benefit politicians and

bureaucrats who use them for offering political favors and enriching themselves. By establishing an extensive screening process for entrants, entry becomes costly and keeps many potential competitors out. This benefits those insiders who have already paid their bribes and now obtain supernormal profits. Here, more regulation means fewer socially desirable outcomes.

Djankov *et al.* name these alternative schools of thought as "helping hand" and "grabbing hand" theories. They find considerable evidence supporting the latter view. Increased regulation of entry is not associated with higher quality products or better environmental standards, but rather higher corruption, a larger "gray" economy, and other undesirable socio-economic phenomena.

That said, we proceed under the assumption that extensive regulation is, on average, undesirable and, therefore, more entry screening, longer time spent on it, and attendant higher cost are disadvantageous to formation of *de novo* firms. Looking at the data supplied by Djankov *et al.*, we note that our selected successful transition countries are roughly in the middle third of the surveyed sample. Out of 75 countries, Poland ranks 28th or 29th, Hungary 45th, and the Czech Republic 51st.

Among European transition countries, the highest rankings go to Slovenia (12th), Latvia (15th), Bulgaria (19th), and Ukraine (23rd). These ranking are calculated by this author as Djankov *et al.* do not actually calculate an aggregate indicator for the number of procedures, time needed for their completion, and the cost of establishment in terms of a percent of annual GNP *per capita*. For the record, the highest rankings go to Anglo-Saxon countries and Scandinavian countries. The 'core' European Union countries cover the entire spectrum from Belgium (13th) and Germany (26th) at the top to France (59th) and Austria (67th) at the bottom. Select rankings appear in Table 3.

Table 3. Select countries ranked by ease of entry (using three indicators: number of procedures, time spent registering, and cost as a percent of annual GNP per capita)

Rank	Country
	Top Ten
1	Canada
2	New Zealand
3	Australia
4	United States
5	Sweden
6	United Kingdom
7	Denmark
8	Finland
9	Norway
10	Ireland
	European Transition Economies
12	Slovenia
15	Latvia
19	Bulgaria
23	Ukraine
28-29	Poland
37	Romania
39	Lithuania
45	Hungary
48-49	Slovakia
51	Czech Republic
54	Croatia
63	Russia

Source: Calculations based on data in Djankov *et al.*, 2000. No data on Estonia were included.

There are no similar comprehensive surveys on regulation of company operations. This is understandable, since so many factors influence corporate performance. In theory, though, the same principle applies: more regulation means higher barriers, and higher barriers mean worse performance. With respect to the regulatory framework concerning operations of businesses,

the concerns of new firms, and the existence of high barriers are captured by various country studies and business opinion surveys.
A series of studies on the countries under consideration (E. Balcerowicz *et al.*, eds., 1999) presents shared views of barriers facing entrepreneurs in all three countries:

- Very high burden of taxes and social security contributions (50-100% higher in terms of share of GDP than in mature West European economies); and
- Excessive regulation, frequent changes in the regulatory regime, and lack of transparency.

Both types of barriers lead the lists of existing barriers facing entrepreneurs in Poland, Hungary, and the Czech Republic. The Balcerowicz studies also include surveys of Lithuania and Albania, which, unsurprisingly, find similar results. These barriers may, in fact, be near-universal for new entrepreneurial firms in transition economies (and in other in underdeveloped, distorted economies).

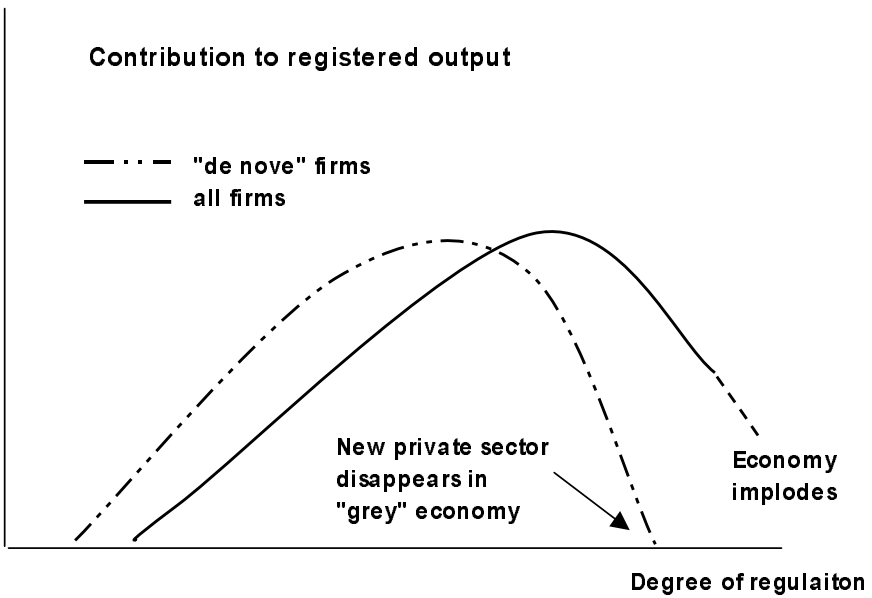
The third set of barriers, also uniformly mentioned, was financial barriers. Small and middle-sized firms, in particular, were at a disadvantage in terms of obtaining external (bank) financing, so retained profits played a much larger role in SMEs than in large firms (see country reports, Kondratowicz and Maciejewski, 1996, E. Balcerowicz *et al.*, eds., 1999). Thus, the double-whammy of high taxes and lack of access to financing strongly curtailed opportunities for SMEs to expand.

The implication is that high taxes and extensive regulation are more costly for small and middle-sized firms than for large ones. The latter relationship has already been subjected to some empirical verification. A study of the Netherlands established that the cost of compliance with the regulations was almost six times higher in firms with less than 10 employees than in those with more than 100 employees: *Ecu* 3,500 vs. *Ecu* 600 (see Stein *et al.*, 1995, quoted in Benacek, 2001).

The Laffer curve of regulation in Figure 3 presents two peak points (a shift to the right of each produces declining performance). One peak point

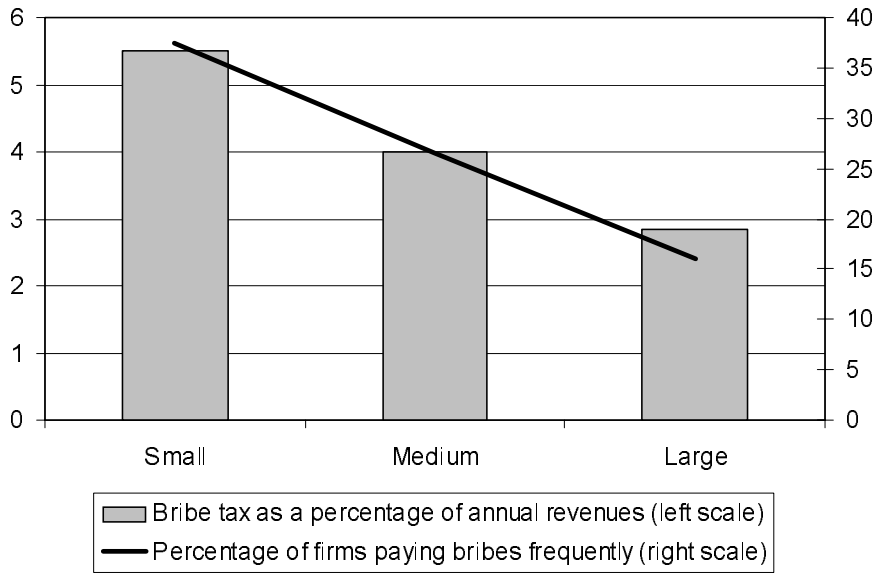
represents for the population of all firms; the other – substantially to the left – shows the population of SMEs. The performance of the latter begins to weaken much earlier under the impact of the same set of rules for all firms.

Figure 3. Laffer curve of regulation showing stronger impact on *de novo* private firms



The higher cost of regulation, with its performance consequences, applies not only to compliance costs, but to all costs related to regulation, including corruption costs. The study of corruption undertaken by the EBRD, covering transition economies also revealed, unsurprisingly, that the "bribe tax" (payments to officials) take a substantially higher share of annual revenues from small firms than medium and large firms. The ratio of the relative size of the bribes paid by small and by large firms is more than 2 to 1 (Figure 4).

Figure 4. The impact of the "bribe tax" depends on the firm's size



Source: Transition report, 1999 EBRD

The impression here is that the regulatory framework clearly matters and transition economies would greatly benefit from reduced taxation and liberalization of their regulatory regimes. Such measures could accelerate economic growth in the successful countries, and even make the difference between success and failure in transition.

Nevertheless, in line with our earlier thesis, liberal rules of establishment and operation of firms may not be decisive for creating a framework conducive to the new entrepreneurial private sector. They create necessary, but not necessarily sufficient, conditions for success. Recalling Djankov *at al.* (2000), we note that Ukraine had a much higher position than Poland, Hungary, or Czechia in the ranking of the ease of entry for firms. Given that Ukraine has registered one of the worst performances in terms of its transformational recession path and the meager size of its new private sector it should be obvious that other factors are also at play.

One partial explanation is offered by Kaufman and Kaliberda (1996), who found that 64% of prospective Ukrainian entrepreneurs paid on the average an equivalent of $186 to expedite the registration of a firm. Other business-related activities also frequently required bribes (between 56% and 97% of cases, depending on the activity!). Corruption itself is a product of unfinished or distorted transition program, creating opportunities for the bureaucracy to demand bribes. At a more general level, it is a consequence of weak traditions of law and order in a society.

4.3 The New Private Sector, Transition Progress and Systemic Fundamentals

Thus, the story of success of the generic private sector does not end with a robust regulatory regime, even one legislating far-reaching enterprise freedoms. Other factors matter more (see Winiecki, 1999 and 2000a).

Empirical studies almost uniformly support the view that progress in the implementation of a transition program is crucial. Moreover, progress in implementation of stabilization, liberalization, and privatization measures is carefully tracked by international institutions such as the World Bank and EBRD, as well as individual analysts.

Of the variety of indicators developed to measure progress, even the crude ones reflect actual progress. Coefficients of progress in transition, for example, correlate positively with actual progress as measured by GDP growth, inflation decline, foreign trade dynamics and structure, and other measures of economic performance. Countries with higher values for their aggregate institutional performance indicators are also typically best in terms of economic performance.

These views so far are mainstream. Looking further, however, into the relative success of nations in creating conditions conducive to the establishment and expansion of the new private sector, we find the impact of institutions goes far beyond the successful pursuit of stabilization, liberalization, and privatization – the "Holy Trinity" of transition.

Beyond this are wider, fundamental political, economic, and societal phenomena. The institutional story must be set in a context of such issues as the wider framework of liberty, law and order, and trust. The following points are summarized from an earlier paper (Winiecki 2000a).

- Freedom of entrepreneurship, as embodied in a regulatory framework conducive to the establishment of a new private sector, is especially important for new participants, who bear the disproportionate cost of any barrier to entry and expansion (relative to larger, established firms). While economic liberty embodied in liberal regulation is good for performance of *de novo* firms, the regulatory framework must interact with (or be embedded in) a larger framework of liberty. It is this framework of liberty, rather than the more narrowly conceived freedom of entrepreneurship, that is needed to give potential entrepreneurs the assurance of political stability and protection from any later persecution for their pursuance of profit through the operation of a private firm.

  This is a minimum requirement, but a vital minimum in countries where private profit-seeking was once a crime. Even where the constrained private sector was allowed to exist, entrepreneurial activities were often seen as evil. Moreover, entrepreneurial success often breeds envy, discrimination and even persecution. This becomes the price of success in places where the framework of liberty is weak or absent.

  Incidentally, this lack of assurances is what condemned attempts to revive private entrepreneurship under East European "reform communism." No constitutional rules or policy pronouncements (the proverbial "green light" declared by communist rulers) helped regimes generate the dynamic expansion of the generic private sector. Would-be entrepreneurs immediately saw that their communist rulers simply were not credible. As a result, the entrepreneurial response was generally limited and distorted (most registered effort went into activities with short-term objectives). A comparison of the rate of formation of new firms in the pre-transition period and early

transition period (see country reports and Kondratowicz and Maciejewski, 1996), when the emergence of political liberty occurs, is instructive here.

- Well-designed, strongly enforced property rights are goals of every transition program, albeit realized to varying extents. Even the best-performing countries leave much to be desired (EBRD Transition Report 1999). Again, the property rights' regime, while significant in enhancing economic development and expansion of the entrepreneurial sector, is only part of the required institutional framework protecting the property of economic agents.

  To be more precise, it matters whether some sophisticated types of deals will not be entered into, given the imprecise rules or weak enforcement of property rights. It matters even more if standard types of transactions are not made because economic agents feel unprotected due to a lack of law and order.

  Thus, the perception of the existence of *an efficient law and order regime* is a prerequisite of the successful privatization-from-below. Wherever it is absent, due to the weakness of the (otherwise highly activist) state in pursuing its fundamental task as a provider of law and order, transaction costs rise enormously. If property can easily be stolen, extorted, or damaged by criminal elements that operate with impunity, then the best-designed property rights will do little to spur healthy entrepreneurship.

- It is important that trust develops over time as the honesty becomes increasingly rewarded through repeated business deals with those individuals whose reputation for honest dealing becomes established. The capitalist market economy is well suited to developing such trust, given the concordance of the structure of incentives with reputation-enhancing behavior.

  What is also needed, however, is a dose of trust that is not so much the outcome of the interactions on the market, but an ingredient indispensable for the emergence of a market that operates with

low-transaction costs. General trust is more a consequence of the protracted existence of a *civil society*, wherein citizens willingly organize themselves for the common pursuit of various goals. Interaction across political, religious, and other divides teaches cooperative behavior and prepares members of society to accept the duties required for the advancement of mutual causes.

Such *social capital* (Putnam's term) or *public good human capital* (Olson's term), or simply *trust* (Fukuyama's term) is usually low in societies emerging from the communist system (see survey comparison in Lovell, 2001). Whatever trust exists at the start of transition was inherited from a pre-communist past, implying that countries embarking on the path of transition begin with different endowments of trust. Even so, it is always essential that those taking part in the capitalist market economy, investing their time and money, trust the stability of the fundamental social-economic order.

Those already in business and would-be entrepreneurs need assurance that there is a high degree of continuity, that compromises between conflicting interests are possible, and that electoral results will not change the regulatory or policy landscape overnight. The more civic interactions in pursuit of various interests occur in a given society, the higher the trust, and, as a result, continuity. With low trust and little prospect for continuity, the time horizon for entrepreneurs is shortened considerably and the new private sector will be substantially smaller and oriented toward short-term gains.

In summary, liberty, law and order, and trust are the systemic fundamentals that underpin transition. No matter how well designed and executed transition measures are, the lack of the fundamentals will seriously undermine desired outcomes.

In the introduction to my 1989 book "*Resistance to Change in the Soviet Economic System*" (Winiecki, 1991b) I wrote that clear-cut political change is a crucial signal to the present and future economic agents that systemic change is real and irreversible. Whenever that signal is missing or unclear, the probability of success in economic change is low or nonexistent. The experience of the past decade amply proves this.

5 Confronting explanations and realities

5.1 Overview

In the preceding sections, we considered transition-specific features of the new, entrepreneurial private sector, and outlined two alternative output paths in post-communist transition that highlighted the role of the new private sector in economic recovery from transformational recession and in the subsequent expansion. Finally, we examined the determinants of success, applying three levels of generalization. We now look at the post-communist realities of the last decade with respect to the new entrepreneurial private sector.

Fragmentary national sources partly explain the dearth of reliable statistics that are comparable over time and across countries. However, international institutions with sizable resources also have failed to generate sophisticated statistics on the SME sector (or the new private sector) or its contribution to transition.

Data on the new private sector tend to be more are available in successful transition countries, in particular the Czech Republic, Hungary, and Poland. Statistical data are much scarcer in less successful countries, in line, perhaps, with the scarcity of the new entrepreneurial private sector.

In Poland, Hungary, and Czechia (when the region was still part of Czechoslovakia), the new private sector grew rapidly in early years of transition as aggregate demand fell. Even with the general retrenchment, new private firms expanded rapidly, satisfying new, market-based demand and - within two to three years - generating a substantial share of aggregate output and GDP. The three country reports, as well as other studies, put that share at 20-25%, with the subsequent increase to 40-45% and more at the end of the first decade of transition. Among the generally recognized best performers (the three above-mentioned countries, plus Estonia and Slovenia), and the modest successes (Latvia, Lithuania, Slovakia) only one displayed significant differences with the pattern described above.

Slovenia, undoubtedly a good performer, registered a relatively lower aggregate share of the private sector in output and employment, and relatively weaker dynamics in its entrepreneurial sector. Its privatization arrange-

ments were based on inherited post-Yugoslav institutional idiosyncracies that skewed the ownership structure of privatized firms in favor of less efficient types of private ownership (insider-owned firms) and maintained a bloated public enterprise sector. This happened, as noted by Simoneti *et al.* (2000), "at the expense of economic efficiency."

Slovenia's vital economic performance probably stems from the Slovene economic experience. Before WWI, Slovenia and Czechia formed the industrial heartland of the Austro-Hungarian empire. In inter-war and post-WWII communist Yugoslavia, Slovenia remained the most developed part of that country. It enjoys the highest living standard among the post-communist economies. Given the relative economic openness of communist Yugoslavia, it has also been most exposed to economic competition in the West (thus requiring less adjustment as Slovene firms were already accustomed to dealing with Western markets under the old regime).

This level of development explains much of Slovenia's performance. It also helped in establishing a relatively less intrusive regulatory regime (again, note Slovenia's 12th place ranking with respect to regulation of entry - the highest of any post-communist economy). Over time, of course, as Slovene enterprises are increasingly forced to compete on equal footing with EU firms, the disadvantages of a distorted structure of ownership will become increasingly visible, while the opportunity to subsidize the inefficient increasingly curtailed. For the moment, however, Slovenia lives partly on its comparative advantages inherited from the past.

In all success stories, the fundamental requirements set forth in the preceding section are better met than elsewhere. For example, the change in the political system could hardly have been more marked. Law and order, which still leaves much to be desired, has been nonetheless be markedly better achieved in successful transition countries. Protection of property rights has also been better, and corruption has been lower.

Please note that in terms of level of the "bribe tax" and "time tax" (senior management time spent dealing with authorities), Slovenia is the least affected of all transition economies with systemic distortions. Other East-Central European (ECE) economies follow, with Hungary and Estonia doing somewhat better here than Czechia and Poland. Relatively good condi-

tions in Croatia and Bulgaria should be noted as well (the foregoing comparisons are based on Transition Report, 1999). The five most successful countries, plus a few more from the same ECE group (including the Baltic countries), would also be those, where one would expect to find more trust inherited from the pre-communist past.

With respect to level of systemic fundamentals, the five top performers, joined by a few more countries from the same region, create the most conducive conditions for the establishment and expansion of the generic private sector. The same may be said about their progress in stabilization, liberalization, and privatization-from-above, as evidenced by various rankings from international institutions and other sources.

Ranking in accordance with the regulation of entry and operations and their impact on the new entrepreneurial private sector is a nontrivial exercise, given the large variety and number of possible indicators. Moreover, specific arrangements may not necessarily indicate conditions conducive to the new private sector in the absence of higher-level determinants. Tax and regulations barriers may be less painfully felt in the presence of, say, an increasingly stable macroeconomic framework, including falling inflation and a stronger law-and-order regime.

The fact that, say, in the Czech Republic, the entry screening includes a requirement of obtaining a positive opinion from the local administration, is not required in Bulgaria, puts potential Czech entrepreneurs at a disadvantage relative to their Bulgarian counterparts. It is duly reflected in the lower ranking of Czechia in the area of entry regulation (51st vs. 19th). However, this is compensated for by other characteristics such as the higher probability of Czech new private firms obtaining bank financing (and earlier in the life of the firm) than in Bulgaria.

The comparative position of the best performers bears similarity to the behavior of cyclists in the lead pack of the *Tour de France*. Occasionally, a cyclist from the *peleton*, the main cyclists' group, comes up to join the leaders, only to eventually fall back into the main pack. The lead pack never seems to worry much about such transient visitors.

Returning to neo-institutional approach, higher-level determinants are most important. Polish, Czech, or Hungarian entrepreneurs may be quite

justified in complaining about taxes and regulations, since their impacts are much stronger than on entrepreneurs in core EU countries, to say nothing of the Anglo-Saxons and Scandinavians. Nevertheless, given their conducive fundamentals and steady progress in stabilization, liberalization, and privatization-from-above, they perform much better under the similar detailed and intrusive regulations.

5.2 Leaders and Laggards: Qualitative and Quantitative Differences

The gulf between good ECE performers and the rest is probably best exemplified by the comparison between Poland and Russia. It is generally agreed that Poland is an economic success story, while Russia is not (although few actually appreciate how changed Russia is in political-economic terms from its communist past, see Mau, 2000). Where analysts differ is the causes.

There is little disagreement with respect to Poland's success. The basic transition story goes something like this: Strong stabilization measures at the start of transition and rapid liberalization were seen as necessary to force adjustment of the state enterprise sector. Early initiated (albeit slow) privatization-from-above helped push firms from the inefficient state sector to the efficient private sector. To an extent greater than anywhere but Hungary, bad performers were allowed to fail (although the actual exit often took a while). This created conditions conducive to the early recovery that started already in mid-1992. From then on, Poland enjoyed, more or less, smooth sailing.

Recalling the discussion on section 3 on alternative output paths, it should be easy to spot the weakness in this mainstream narrative - it says nothing about who generated all that output growth! Even if SOEs and privatized firms adjusted to new market conditions, they did not generate a net output increase in early transition.

The mainstream story of Russia's failure is a mirror image and equally lacking. Thus, we are told of the failed stabilization (with the government and the central bank working most of the time at cross purposes), the erratic and incomplete liberalization, and the impact of privatization-from-above fail-

ures. Privatization was showcased as one of the few success stories in Russia's yet-to-be-completed transition. Under this story, stabilization and liberalization failures prevented progress in ownership transformation. It was unstable macroeconomic conditions and microeconomic interference that made buyers unwilling to purchase Russian firms from their incompetent insider-owners. The necessary restructuring step of putting firms in the hands of strategic outside owners (the most efficient form of private ownership) never happened. The result was continuing output decline and a much delayed - and weak - shift from recession to recovery.

Again, this story, just as in Poland's case, glosses over the fact that early output recovery is not generated by SOEs or privatized firms, but as we now know by new private firms. Why does it matter to the storytellers that SOEs failed to exit or become efficiently privatized?

Let us consider a counterfactual scenario. Assume Russia started with a successful transition, that it pursued consistent macroeconomic policy and, as a consequence, markedly increased stability. Also, imagine that Russia liberalized rapidly along the same lines as Poland. Does this, in accordance with mainstream reasoning, ensure early recovery? Of course not! In Poland, SOE output declined for five consecutive years (1990-1994). During that time, the contribution of privatized enterprises to output was low - lower, in fact than before the start of transition.

These mainstream narratives about Poland and Russia say nothing about the new entrepreneurial private sector. They do not explain why Polish GDP stopped falling in the third year of transition or why Russian GDP fell seven years in row (it finally stopped in 1997, when GDP rose 0.8%). The output recovery beginning in 2000 is better understood as a recovery of output of privatized ex-SOEs at the expense of imports after the dramatic depreciation of the ruble.

Clearly, the differences between Russia and Poland must lie elsewhere. As stressed in the preceding section, the differences are between the fundamentals in both countries. Russia's relative success in privatization-from-above was hampered because Russia failed not only to achieve macroeconomic stability and liberalize its economy, but also, if not primarily, because none of the fundamentals that underpin success in transition were present.

Without those fundamentals, including the clear-cut perception of irreversible political change and the strongly enforced law and order, the level of risk associated with the entrepreneurship remains extremely high.

The foregoing affected both privatization-from-above (few outside takers for Russian insider-managed firms) and privatization-from-below. The level of entrepreneurship, as evidenced by almost any indicator, has been very low. Compared to Poland, where all the fundamentals may be regarded as being, more or less, present, the level of entrepreneurship is vastly lower. The rough measure of the number of entrepreneurs per 1000 of population in late 1990s, presented for a number of transition economies in Table 4, yields the ratio for Russia almost ten times lower than for Poland.

Table 4. Entrepreneurial density in selected transition economies (number of entrepreneurs per 1,000)

Country	Year	Ratio
Czech Republic	1998	139
Hungary	1998	64
Poland	1998	59
Slovakia	1998	56
Slovenia	1998	32
Romania	1998	15
Russia	1996	6

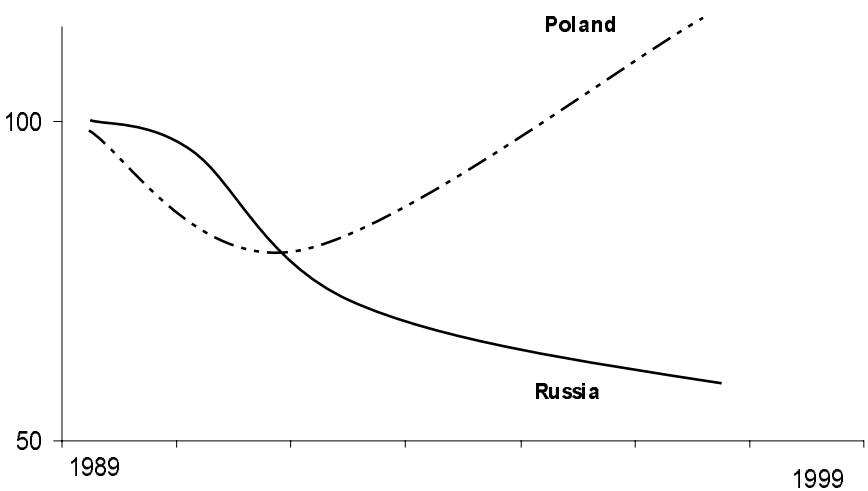
Sources: Winiecki 2000a

Other measures, such as the share of employers and self-employed in total employment outside agriculture show major differences, too. Incidentally, the perception of the leading pack and the rest are strengthened by the use of the indicator in Table 4. Czechia, Hungary, Poland and Slovakia clearly belong to the same category, with Romania and Russia registering ratios 4-

10 times lower. Again, Slovenia, as noted earlier, is located in between the two groups. There are no data for Ukraine for entrepreneurship intensity, but the comparison of the share of employers and self-employed in the total labor force shows the ratios for Hungary and Poland being about eight times higher (see Transition Report, 2000).

A major weakness of all these data is their failure to account for the "gray" economy. The inclusion of the gray economy would probably reduce the yawning gap between transition hopefuls and transition laggards. Then again, the weakness in question probably matters little with respect to the concerns elaborated here. After all, the size of the gray economy indicates the extent of transition failure. If one were to compare the share of the gray economy across transition countries with the transition progress in institutional terms, the inverse correlation between the progress in transition and the relatively low share of the gray economy would be clearly visible.

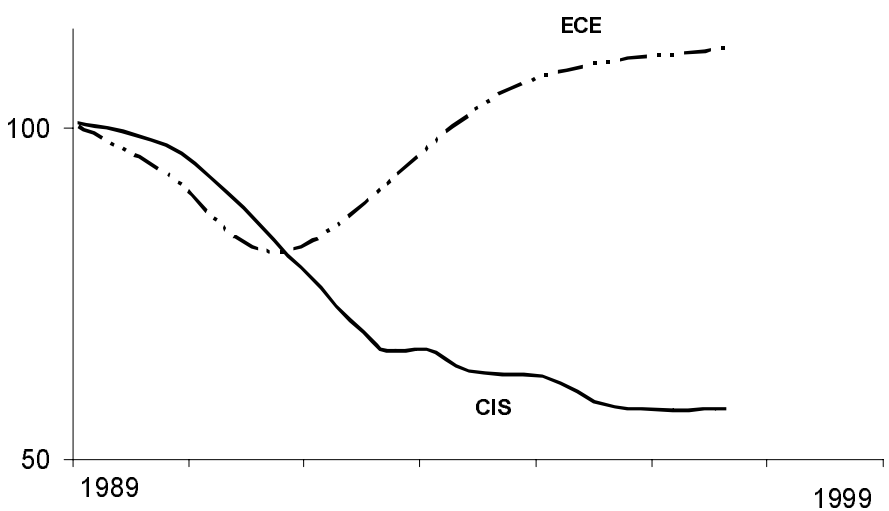
Figure 5a. Alternative real-life output paths in Poland, a transition leader where new private sector expanded dynamically, and Russia, a transition laggard, 1990-1997.



Basically, informal entrepreneurship is an inferior form of entrepreneurship. De Soto (1989), in his frame-breaking study of Peru, provides a compelling discussion of the alternatives to operating in a low-transaction-cost capitalist market economy. Informal, or "gray," entrepreneurs cannot enjoy the normal benefits of economic agents in a formal economy. They do not benefit from the existing financial system, their ability to grow is limited, and their firms are exposed to greater risk of extortion from those in authority. Operating in a gray economy is a reaction to the emergence of the rent-seeking political class and bureaucracy that throttle or at the very least strongly constrain the opportunities for healthy economic development.

Coming back to our juxtaposition of Poland and Russia, we may now attempt to draw real-life output paths for both countries. It has been done in Figure 5A. A confrontation of the stylized output paths in Figure 2A&B and the actual GDP paths for Poland and Russia in Figure 5A confirms the strong concordance between stylized facts and reality.

Figure 5b. Alternative real-life output paths in transition leaders (East-Central Europe, including the Baltics) and transition laggards (CIS countries), 1990-99



Once again, the leaders and laggards, the relatively successful and relatively unsuccessful fall into two distinct groups, with the former following Polish pattern and the latter following Russian pattern. The indexes of real GDP for East-Central Europe (including the Baltics) and the post-Soviet countries (the Commonwealth of Independent States), present clearly different output paths. Figure 5B from the EBRD Transition Report (2000) reflects this. Similarity between the respective paths in part A and B of Figure 5 evidences to the existence of two groups of countries.

6 Final comments

In the previous sections, we considered the role of the new private sector, its impact on recovery and expansion, and the determinants of its success as an engine of the transition economy in the early to medium run. A few additional comments are in order.

First, there is the usual plea for more data. Data on the generic private sector is absent from most regularly collected statistics. Even statistics on small and middle-sized firms, beyond rudimentary data concerning shares in employment, are published only occasionally. Moreover, these data are rarely supplied formats that are comparable over time and across countries. The apparent crucial role of the new entrepreneurial private sector in transition argues strongly for greater efforts in data collection on this sector.

Second, the hierarchy of determinants of performance of the new private sector and the dominant role of systemic fundamentals do not absolve policy-makers from striving for lower taxes, simplifying regulations, and generally reducing the burdens on SMEs. These burdens bear strongest on new and small firms. Moreover, in even the best performers in transition, overregulation increased in the second half of 1990s as bureaucracies and politicians rediscovered the joys of rent-seeking under new institutional arrangements. High taxes positively correlate with inferior entrepreneurship - the gray economy (S. Johnson *et al.*, 1998).

Finally, for those who believe that political and economic liberty are not limited to a certain subset of countries privileged by history (for post-com-

munist Europe, see Winiecki, 1997), our findings here should be good news. Free market economies can be established in what was once Eastern Christendom. It may take, however, much more time than in countries that have allowed individual initiative, personal choice, and entrepreneurship for centuries.

In the meantime, being a transition laggard does not make a country communist. Some post-communist countries still cling to superficially reformed centrally administered economies, but only a few. The rest, including our three case studies (Poland, the Czech Republic, and Hungary), are high-transaction-cost economies on a long - and bumpy - road to well functioning markets.

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