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Chapter Author: Simon Johnson

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16 Private Business in Eastern Europe

Simon Johnson

Amid all the bad economic news from Eastern Europe in the past two years, there has been at least one consistent source of optimism—the rapid development of the private sector in some parts of some countries. But it remains far from clear whether this development will be fast or deep enough to carry these economies out of their recessions soon. It is also not fully clear why the private sector has developed faster in some places than in others.

The policy issues are important. Is there anything that a post-Communist government can do to speed up private-sector growth? Is there one type or path of economic reform that particularly stimulates the private sector?[1] Even in those countries where the private sector is relatively strong, can it provide the basis for a modern, industrial economy? These are important questions not only in Eastern Europe but also now in the former Soviet Union.[2]

This paper makes three main points that address these issues. First, comparative evidence reveals that the private sector is weak in the Czech and Slovak Federal Republic (CSFR) and much stronger in Hungary and Poland. Second,

The methodology used in the interviews reported here was developed with Piotr Strzalkowski and is part of a continuing project with him. His associates at MCR Research supervised both the interviews and the collection of information from other East European countries. Without their creative and inspired participation, this paper would not have been possible. The author would also like to thank three research assistants who very ably helped him collect and interpret data: Lloyd Melnick, Sapan Parekh, and Erik Whitlock. Helpful comments were provided by Peter Rutland, Kalman Mizsei, and Pawel Dobrowolski. The National Bureau of Economic Research generously financed the collection of cross-country survey information. Interviews with businesses in Poland were paid for with funds provided by the Fuqua School of Business, Duke University.

1. One of the arguments used in support of the "Chinese path" is that it helps nonstate enterprise to develop (McMillan and Naughton 1992, 4–6) and that this forces the state sector to become more competitive.

2. This paper will deal explicitly only with Eastern Europe. For an analysis of the emerging nonstate forms of enterprise in various parts of the former Soviet Union, see Johnson and Islamov (1991) and Johnson and Kroll (1991, 1993) and the references given there.

current government policies targeted at the private sector in all three countries are too similar to explain the difference in private-sector strength. Changes in taxes, credit conditions, and property reform have all proceeded along similar lines, yet the outcome in terms of private-sector performance has been quite different. Third, the most plausible explanation for differences in post-Communist private-sector performance lies with the different reform policies pursued by respective Communist regimes during their rule.

Continued private-sector growth is not surprising in Hungary, where the Communist regime allowed private-sector development on and off since 1968 and fairly consistently during the 1980s. However, economic reform in Poland is usually considered to have begun relatively recently, and the relative strength of its private sector needs further explanation. Therefore, I also provide more detailed evidence on the development of the Polish private sector, including the results of interviews conducted with a sample of private businesspeople in December 1991. In my assessment, the Polish entrepreneurs who have done well are those able to take advantage of the way in which economic reforms were sequenced from 1981 to 1991.

There is not a great deal of existing literature on the private sector of Eastern Europe. An excellent comprehensive survey of the private sector in East Germany and Poland up to the early 1980s is provided by Aslund (1985), and Seleny (1991) reviews the development of private business in Hungary, with particular emphasis on the 1980s. A number of papers have been written recently on the general situation of the private sector and the policies needed to stimulate its development, but most of these are general and do not contain much concrete detail. Important exceptions include an excellent review of the problems in the CSFR by Rondinelli (1991) and an interesting survey by Brandsma (1991). There are also some useful overview papers on the recent development of small business in the CSFR (McDermott and Mejstrik 1992; Capek 1990), Hungary (Hare and Grosfeld 1991; Galasi and Sziraczki, n.d.), and Poland (Piasecki 1991; Grabowski 1991; and Grabowski and Kulawczuk 1991b).

There has been surprisingly little empirical work based on interviews with entrepreneurs. At least one random-sample survey of private firms has been conducted in Gdansk, Poland (Grabowski and Kulawczuk 1991a), and an analysis of rural entrepreneurship in Hungary is available, based on data from the 1970s and early 1980s (Szelenyi 1988). Other studies have examined small, unrepresentative samples—such as interesting networks of private firms (see, e.g., Johnson and Loveman 1993). A World Bank comparative study of private manufacturing in the CSFR, Hungary, and Poland has also been announced, but its results are not yet available.

The remainder of this paper develops the three main points outlined above. Section 16.1 discusses the generic situation of the private sector under communism in Eastern Europe, and section 16.2 examines the available data on the development of the private sector in the CSFR, Hungary, and Poland over the past two years. Section 16.3 describes both the methodology and the results of our interview-based field research. Section 16.4 concludes with the important lessons. There is also an appendix that explains in more detail how our sample of Polish private entrepreneurs was selected.

16.1 The Private Sector under Communism

The story of the private sector under communism can be quickly told, in part because there is not much to say and in part because other authors have covered this ground thoroughly. This section provides information on how Communist regimes limited private activity because this is important for understanding the current situation of the East European private sector.

There were brief periods in which some Communist regimes tolerated a vibrant private sector, most notably during the New Economic Policy of the 1920s in the Soviet Union (Ball 1987; Kaufman 1962). There were also episodes of relative liberalization for private business, although these were usually followed by a crackdown. Perhaps the best example is Poland, where controls on private business were loosened in the immediate aftermath of various political crises—1956–57, 1965–68, 1977–80, and after 1982 (Aslund 1985, chap. 2). These cycles of policy reflected the tension between Communist ideology—which was opposed to any private-sector activity—and Communist governments' desire to maintain an adequate supply of goods and services. This same tension helps explain why there was frequently tolerance of so-called private plots in agriculture but also repeated clampdowns on this activity.[3] Communist regimes altered their economic policy toward the private sector in line with their current political policies. They had almost total control over their societies, and to crush the private sector they could use policy instruments that ranged from violent repression to altering tax rates. The simplest and most common policy was to declare most or all private activity illegal.

Even when legal, private business faced many constraints. Among the most significant were the difficulties associated with obtaining material inputs. Industrial supplies were hard to get, and the most desirable supplies were tightly controlled by state planning and supply agencies. Any private manufacturing operation, such as existed in the Polish handicrafts sector, relied on the state for its inputs and was therefore always vulnerable to a change in the political mood. In many cases, there were also restrictions on the use of labor by the private sector, usually in the form of statutory limits on the maximum number of employees in a private firm.

There were usually onerous taxes on private business. Tax rates were both high and unstable—it was hard to forecast future private-sector tax liability. In

3. The only significant private activity that remained in Eastern Europe by the 1970s was Polish agriculture, which was primarily private. However, both its supplies and its products were tightly controlled by state trading agencies.

some instances, important details of the tax regulations were not published, and local tax offices would have considerable discretion. Private businesspeople lived in fear of an investigation by tax inspectors with draconian powers.

Of course, the state tightly controlled the banking system. In all East European countries there was a monobank, so called because all functions of a central and commercial bank were effectively fused into one institution. This monobank oversaw all credit in the economy, with the goal of ensuring that it was allocated in support of the economic plan.[4] There were some supposedly independent cooperative banks, for example, for Polish agriculture, but in practice they were tightly controlled.

At the beginning of Communist rule, these regimes could seize any property they wanted.[5] As time went by and the political situation changed, the state became less inclined to use brute force against its citizens. There were exceptions, of course, and we know that the use of such force was seriously considered during 1989 by some East European governments. Communist states reserved the right to act with force against any perceived opposition, and the state's perception of what constituted opposition could change very rapidly. Actual and would-be private businesspeople were well aware of this fact.

In the mid-1960s, the private sector in Czechoslovakia, Hungary, and Poland was extremely weak and—with the exception of private agriculture in Poland—constituted a marginal economic phenomenon. In all three countries, we can consider the private sector as beginning from a similar starting point. Interestingly, as the next section shows, by the early 1990s there were significant differences among the private sectors in these countries.

16.2 Survey of Available Evidence

There is a lack of good data on the current situation of the private sector in Eastern Europe. Existing official statistical systems were constructed to monitor the performance of state enterprises, and they have been modified only slowly to measure new nonstate business. Unfortunately, Eastern Europe also lacks well-developed private sources of information, such as consultants' reports and local academics' research papers. While there are Western private consulting, accounting, and law firms operating in all three countries with the express purpose of providing detailed information on how to operate a (Western) private firm locally, we could not afford to buy the advice of these firms.

Our approach was to commission consultants' reports for each country.

4. The functioning of the credit system under communism is reviewed by Johnson, Kroll, and Horton (1993).

5. In some cases, this was not a legal right but simply the result of the state's coercive powers. For example, the property of some small firms was "nationalized" in Poland and Czechoslovakia illegally—i.e., this action was not legal even under the Communists' laws.

These reports were prepared during the fall of 1991 by independent researchers in each country, in the form of responses to a questionnaire.[6] As far as possible, all responses were checked by researchers in the United States against sources available here. Some inadvertent errors probably remain, and in addition we need to attach an important caveat to our description of tax rules. Tax regulations in these countries are currently very complicated and in flux.

Our survey covered Bulgaria and Romania, as well as the CSFR, Hungary, and Poland. However, the information provided for Bulgaria and Romania was less well documented and harder to check in the United States. Furthermore, it was clear that the urban private sector in Bulgaria and Romania was in a similar situation to that of the CSFR. Compared to Bulgaria and Romania, the CSFR is widely considered to have advantages—such as location and a strong industrial tradition—so we concentrated on the CSFR, reasoning that it should have the best potential for private-sector growth among those countries that ended the Communist era with only weak private business.

For each country I offer an organized set of facts. First and most important, I present all available information related to the number of private firms and the scale of their activities. Second, I review the current situation on a number of previous constraints that the Communists used to restrict the private sector. I answer the following questions. Is there now equal legal treatment of the private sector? Are there still shortages of inputs, and can all goods be freely exported and imported? Does the private sector have any tax advantages or disadvantages? Is there a banking system that is willing and able to lend to the private sector at reasonable rates of interest? Do private businesspeople have assets that they can use as collateral? More generally, what government policies are in place to help the private sector, and have they had any noticeable effects? I refer here not only to policies that are explicitly targeted at the private sector but also to more general macroeconomic policies that may have important indirect implications.

Third, I present evidence on a development that is proving important for the future prospects of the private sector—the privatization of shops and small firms. It is not the goal of this paper to explore in detail privatization plans, but it is a relevant issue to the extent that it creates new entrepreneurs or helps existing private businesses to expand.

I look first at the CSFR, using it as a benchmark because its private sector is so weak. This makes clearer the relative advantages and remaining problems that I examine for Hungary and Poland.

6. Simon Johnson drew up the questionnaire, and MCR Research contacted independent consultants in each country and supervised all the administrative arrangements. Consultants were paid only when they sent by fax a response to the questionnaire that satisfied MCR. Most of the information received was detailed and accurate and drew on local language sources that were not readily available outside that country. The sole exception was Bulgaria, where it proved impossible to find a reliable person. As far as possible, we checked the information provided with sources available outside the country and did not find any serious errors.

16.2.1 The Czech and Slovak Federal Republic (CSFR)

There were no legal private firms in Czechoslovakia—as it was then called—under the Communist regime. However, this situation changed rapidly after the "Velvet Revolution" of November 1989 caused the downfall of the Communist regime. By the end of 1990 there were a total of 488,000 "private firms," by 30 June 1991 this number had risen to 921,000 (*Tydenik hospodarskych novin*, 12 September 1991), and by the end of September 1991 there were 1.13 million (*Ecoservice*, 11 December 1991). This is an impressive rate of growth, but very few private firms—fewer than 5,000—were incorporated as of 30 June 1991.[7] The remaining "private firms" are actually individuals who are registered as engaged in business, of whom between 25 and 85 percent are estimated to have at least one other job.[8]

By 30 June 1991, the number of registered entrepreneurs in various sectors was divided into the following proportions: 27.6 percent in industrial production, 24.8 percent in construction, 17.2 percent in trade, 9.9 percent in nontrade services, and 20.5 percent in other sectors.[9] The same broad pattern is confirmed by the latest available statistics for registered entrepreneurs at the end of September.[10] The sectoral composition of the CSFR private sector seems fairly stable.

According to preliminary official statistics, small enterprises—defined as those nonstate and state firms with fewer than fifty employees—contributed only 1.92 percent of GNP in the Czech Republic during the first months of 1991. This share was even lower in the Slovak Republic—0.54 percent. The contribution of private firms was also low: 0.07 percent in the Czech Republic and 0.54 percent in the Slovak Republic. Better information will be available only when the tax data for 1991 are available in the spring of 1992.

The current situation of the CSFR private sector is fairly clear. There was a rapid growth in the number of private businesses after the political regime changed, but many of these "firms" represent only would-be entrepreneurs,

7. Ekonom (a CSFR economic news service) reported on 6 December 1991 that there were 2,811 "private firms" in the Czech Republic. This number must refer to incorporated firms, and we assume that there are fewer incorporated firms in the Slovak Republic. This suggests that our estimate of 5,000 incorporated firms is an upper limit.

8. Under law, there are two types of private enterprise in the CSFR. First, there is a private person who is registered as an entrepreneur by the local municipality. For some sectors, registration is possible only if the person can prove that he or she has special skills. Second, there is an incorporated company that may take one of three forms: a joint-stock company, a limited-liability company, or a partnership for which liability is not limited. All three forms require a minimum of Kčs 100,000 ($3,000) in paid-up capital.

9. Further data that confirm this picture were collected by CreditLine and published on 13 July 1991. According to this source, on 1 March 1991 there were 655,000 private firms, of which 28.9 percent were in industry, 25.7 percent in construction, 15 percent in trade, and 10.5 percent in services. "Services" comprised mostly tourist agencies—of which there were 3,500 in the CSFR—and consultancy.

10. The percentage of entrepreneurs registered in different sectors was as follows: industry, 26 percent; construction, 23 percent; trade, 20 percent; travel, 10 percent; and industrial services, 12 percent (Rutland 1992).

and the sum total of private activity is still rather insignificant. There appears to be an entrepreneurial spirit, but can it develop a more substantial private sector?

The answer to this question must depend on current conditions, which could either promote or hold back private-sector development. We need to look at government policy—especially macroeconomic, trade, and public finance policy—as well as the availability of credit and the effects of the privatization process on the private sector.

Very quickly after the November 1989 "revolution," the new government announced that private and state enterprises should now receive equal legal treatment. A constitutional amendment has been adopted, in the form of law number 100/91 Sb., which states that all owners are equal before the law. The government has repeatedly stated that it regards the development of small- and medium-sized private enterprises as essential for the success of the market economy.[11] There now really appears to be no difference in the rights of the private sector in the CSFR and in Western industrialized countries.[12]

Furthermore, the government has established a tight macroeconomic policy that has made possible a substantial degree of convertibility, allowed the liberalization of trade, and eliminated shortages.[13] According to a survey of top industrial managers conducted by the Federal Statistical Agency in April 1991, the supply of domestic raw materials and semifinished goods was considered satisfactory by 71 percent of respondents and unsatisfactory by only 14 percent.[14] As a further indicator of macroeconomic policy changes, unemployment—which was essentially zero in the Communist period—was 6.6 percent for the whole CSFR at the end of 1991. Unemployment was 11.8 percent in the Slovak Republic and 4.1 percent in the Czech Republic.

Most goods can be imported, subject only to certain duties that do not differ according to whether a firm is state or privately owned and that are not very high.[15] There remain, however, several restrictions on payments made abroad—the most important being that, while incorporated private firms can

11. See, e.g., the speech by Minister Dlouhy to the Federal Assembly, reported in *Hospodarske noviny*, 25 September 1991.

12. This statement should not be taken to mean that the whole system of private property already functions as in the West. Still to be resolved are important issues of privatization and the restitution of property seized by the Communists. The effects of these issues are dealt with below.

13. It is important to keep in mind that these shortages were never as severe in the CSFR as they were in Poland during the 1980s.

14. Only 47 percent of respondents were satisfied with the supply of goods from abroad, but, given the lack of import restrictions, this may just reflect expectations that were disappointed when the economy was opened up. Imported goods are expensive for CSFR firms and consumers.

15. An importer is liable to two taxes: first, a customs duty that is a percentage of the landed cost and that depends on the type of good (there are 5,190 different categories); second, a flat import duty (15 percent of the landed cost) that applies to all finished consumer goods. This duty is not charged on raw materials, machinery, and other productive inputs, and there is an exemption for a limited time for some goods—such as computers. In fall 1991 there were announced intentions to raise the customs duty on agricultural products, some electronics, and some textiles while the rates would be lowered on raw materials and spare parts.

purchase foreign currency with which to buy imports, individual entrepreneurs cannot.[16] Not surprisingly, there is anecdotal evidence that private individuals smuggle goods into the CSFR. As far as we can ascertain, there remain no significant export restrictions. In January 1991, there was still a small black market premium, not in excess of 10 percent—it is hard to know the precise rate because quotes on the street are often designed to attract foreign customers who can be cheated.

Nevertheless, the overall conclusion must be that the new government moved rapidly to establish general legal principles favorable to private business, to free prices, and to create supportive government agencies.[17] However, the government has also been criticized by entrepreneurs' organizations for not having done more, particularly on taxes and credit.

The current tax situation in the CSFR is difficult to specify precisely because the introduction of a new commercial code on 1 January 1992 was intended to change regulations significantly but was not preceded by detailed announcements. On many issues, the previous tax treatment of private business was murky, and the code—based on the German and Austrian models—is supposed to provide clarification. The tax regulations that follow represent our understanding of private-sector taxation at the end of 1991.

Self-employed individuals are exempt from the wage tax, which is a hefty 50 percent. Although there are no hard data, we suspect that a great number of the more than 1 million registered entrepreneurs are actually working for other people and are registered as self-employed only to reduce the cost of hiring them. One supportive anecdote is a private construction firm in Prague that, at the beginning of 1992, had 500 workers—all of whom were officially self-employed.

All firms, irrespective of ownership, face the same rates of turnover tax and social security tax, and all are quite restricted—compared to standard practice in the West—in the range of business expenses that they are allowed to claim as tax-deductible costs.[18] Incorporated private firms are subject to the same progressive corporate tax rates as state enterprises, although there are some advantages for joint ventures.[19] A significant number of the smaller joint ven-

16. An importing CSFR firm must present a valid invoice in order for a payment to be made abroad. However, the CSFR bank will not make the payment for three months if the amount involved is above a certain size—at the beginning of 1991, this was Kčs 1 million ($30,000), but, by mid-1991, it had been raised to Kčs 3 million ($90,000).

17. For example, there is now a Federal Agency for Mediating Foreign Economic Assistance, headed by a former World Bank staff member, and an Agency for Foreign Investment and Assistance at the Ministry of Industry. Active in providing training for CSFR managers are the British Know How Fund, USAID, USIA, and the Swiss Rotary Club.

18. The four basic levels of turnover tax are 0, 11, 20, and 29 percent. The social security tax depends on the level of salary, marital status, and number of children. For example, the social security tax on a monthly salary of Kčs 6,000 ($200) is 8.7 percent.

19. The rate is 20 percent for up to Kčs 200,000 ($6,000) of taxable corporate income, rising to 55 percent for more than Kčs 200,000 for a domestic company but only to 40 percent for joint ventures with capital investment above 30 percent of their paid-up capital. Joint ventures can also

Table 16.1 Personal Income Tax Rates in the CSFR

Annual Income (Kčs)	Tax Rate
0–60,000	15%
60,000–180,000	Kčs 9,000 plus 25% of taxable income over Kčs 60,000
180,000–540,000	Kčs 39,000 plus 35% of taxable income over Kčs 180,000
540,000–1,080,000	Kčs 165,000 plus 45% of taxable income over Kčs 540,000
1,080,000 and above	Kčs 408,000 plus 55% of taxable income over Kčs 1,080,000

Source: Consultant's report.

Note: Personal income tax is regulated by law no. 389/90 Sb. There are approximately Kčs 30.00 to $1.00.

tures are apparently disguised private CSFR businesses.[20] However, a bigger advantage exists for registered private entrepreneurs, who pay personal income tax on their earnings (see table 16.1) and who can claim accelerated depreciation for machinery and some other equipment if it is produced in the CSFR. They cannot, however, carry current losses into a subsequent financial year to offset future tax liability. This package constitutes only slight tax advantages for the unincorporated private sector compared with incorporated private firms and with state firms.

As part of the anti-inflation policy, there are limits on wages that are set by the Federal Ministry of Finance. The permitted rate of nominal wage growth was 9 percent in the first quarter of 1991 and 22 percent in the second quarter.[21] However, in the first half of the year, average wage growth was less than these ceilings allow—there was a real wage fall of about 20 percent. These wage regulations do not currently apply to firms with fewer than twenty-five employees.[22] Again, this represents a slight advantage for the small private sector.

Up to the end of 1991, there were no special incentives or credit policies to

apply for a two-year income tax holiday if earnings are retained in the CSFR and reinvested in privatization or in the development of a retail distribution network. Joint ventures can also apply for accelerated depreciation of capital equipment that is used for domestic production. Commercial banks and other financial institutions should pay 65 percent of their corporate income as taxes.

20. At the end of 1990, there were 1,236 joint ventures, and, by 23 July 1991 there were 2,937. In July, 84 percent of these firms had paid-up capital under Kčs 1 million ($30,000), and 1,187 had only the minimum required amount—Kčs 100,000. There were 22 large joint ventures with capital above Kčs 10 million ($300,000), representing 84 percent of total paid-up capital and 80 percent of all foreign capital in joint ventures. Most joint ventures were with CSFR legal or private persons—only 374 were with state-owned firms. This latter type of joint venture represented nineteen of the twenty-two large joint ventures and only 6 percent of joint ventures with capital less than Kčs 1 million ($30,000).

21. If the permitted wage growth rate is exceeded by more than 3 percentage points, there is a 200 percent tax on the extra payments to workers, and this tax rises to 750 percent if wages rise more than 5 percentage points over the limit.

22. On 25 September 1991, while presenting the government's program for 1992, Minister Dlouhy said that wages in the private sector should be the result of unregulated contracts between employer and employee.

promote small- and medium-sized firms.[23] Credit was available to fund the purchase of assets in the "small privatization" process, but at an interest rate that was not significantly below the usual rates. Recognizing the difficulties of the private sector, on 16 January 1992 the Czech Republic allocated Kčs 1 billion ($30 million) to help small businesses. This program will provide up to a 40 percent subsidy on interest rates and guarantees for 70 percent of the principal. Of course, it is too early to judge the effect of this initiative, but it is unlikely to stimulate the private sector quickly. Why is it so difficult to promote the private sector?

Part of the answer lies in the credit system. The CSFR's financial system is still dominated by state-owned banks. At the start of 1990, the monobank was dissolved and replaced in commercial banking by seven new banks—sometimes called *commercial banks*—although at the end of 1991 the largest of these banks still made almost 50 percent of all loans and the top three banks accounted for more than 80 percent of all credit. The banking system in the CSFR remains much more concentrated than in either Hungary or Poland, and, although most banks are due to be privatized in the spring of 1992, apparently there will not be further demonopolization.[24]

There has been some entry into this sector, but the newer banks still do not account for a large part of credit. By the end of 1990, there were twenty-five commercial banks, and, in August 1991, there were thirty-four banks. With the exception of seven subsidiaries of foreign banks, all thirty-four banks were either state-owned or joint-stock companies having a substantial state share.[25] There are also at least two smaller banks with the stated aim of financing small- and medium-sized firms.[26]

According to the new banking laws passed at the end of 1989, state commercial banks cannot raise capital from outside sources, even though their capital-asset ratio is rather low. The level of losses on bad loans may exceed these banks' own capital, and the banks are reportedly becoming more cautious.[27]

23. However, the Ministry for Economic Development in the Czech Republic has reportedly prepared a law that is intended to promote small- and medium-sized enterprises through changes in taxes and insurance conditions. Funds may also be established that will help provide private firms with collateral (*Tydenik hospodarskych novin*, no. 30 [1991]).

24. The current idea is to place 40 percent of bank shares through the coupon method and sell 10–15 percent to private foreign investors, with the state retaining the remaining shares.

25. Two examples of foreign bank investment are the subsidiary of Creditanstalt, with paid-up capital of $20 million and the creation of a joint venture between Societe General and Komercni banka Praha. Up to the end of 1991, however, most foreign banks seem primarily involved in consulting work.

26. These banks are Slovenska zarucni banka and Banka Bohemia—a joint-stock company with Kčs 70 million ($2 million) in paid-up capital and 52 percent of its shares owned by seven trade unions. Both banks say that they differ from other banks because they do not ask for private property as collateral. The Czech Union of Private Entrepreneurs is negotiating with the German Union of Private Entrepreneurs to borrow DM 100 million ($70 million) at 6 percent for two years. These funds would be used to create a special bank to promote small- and medium-sized firms.

27. One estimate is that, of Kčs 700 billion ($23 billion) total bank credit, between Kčs 100 and Kčs 200 billion cannot be repaid (*Banker*, no. 46 [December 1991]).

Table 16.2 **Prices in the CSFR during 1991 (index with December 1990 = 100)**

	Month						
	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.
Food	133.1	131.8	129.1	128.0	127.9	127.3	127.2
Consumer goods	125.0	140.0	156.0	160.0	168.0	169.0	167.4
Services	110.0	113.0	114.0	121.0	126.0	141.0	140.9
Total CPI	128.0	132.0	141.0	143.0	147.0	151.0	149.2

Source: Tydenik hospodarskych novin, no. 36 (1991), from official statistics of Federalni statisticky urad.

This is reflected in the rising relative proportion of short-term loans, which were 28.1 percent of all credit at the end of 1990 but had already reached 36.2 percent by 30 June 1991 (*Tydenik hospodarskych novin*, nos. 19, 40 [1991]). On 30 June 1991, total credits issued stood at Kčs 662.9 billion ($22 billion), of which only Kčs 24.7 billion ($820 million) were lent to individuals and private business combined, and of which only Kčs 1.5 billion ($50 million) was reported as lent to private business (Brandsma 1991).[28]

Nominal interest rates—which are set by the central bank—fell during 1991, but real interest rates rose dramatically. Nominal loan rates were high at the beginning of 1991—up to 24 percent per year—but they fell steadily. For example, in September 1991, the discount rate was reduced from 10 to 9.5 percent, and the maximum interest rate that commercial banks could charge on credits was lowered even more sharply, from 19.5 to 17 percent. As table 16.2 shows, there were sharp price increases at the beginning of the year, and the high inflation in the first seven months of 1991 implied negative real interest rates. However, in the second half of 1991, prices were roughly constant—retail prices recorded an increase of only 45.3 percent for the whole year (*Hospodarske noviny*, 21 January 1992). Real interest rates must now be considered rather high and unlikely to encourage private borrowing.

Of course, the lack of loans to the private sector could also be due to the requirements of bank lending. In principle, borrowing from a bank is not too difficult. In order to obtain a loan, an entrepreneur has to produce evidence that he or she is either incorporated or registered by a local municipality. The entrepreneur must also specify his or her objectives and provide a business plan and all relevant financial data.[29] In most cases, private property is needed as collateral, and most banks prefer to secure their loans with real estate.

28. Because of the perceived problems with commercial banks, a second round of banking reform was supposed to begin in January 1992 and involve at least partial privatization of banks. However, this round of privatization has now been delayed. It is also unclear how privatization alone will strengthen banks' balance sheets.

29. Compared to Western industrialized countries, we would expect that a lower proportion of people in the CSFR know how to prepare a business plan. However, there are now educational programs in which these skills are taught.

Table 16.3 **The Housing Stock in the CSFR (31 December 1989)**

	CSFR	Czech Rep.	Slovak Rep.
No. of apartments	5,860,286	4,082,357	1,777,929
Of which (% shares):			
State	24.1	27.0	17.4
Cooperative	18.3	17.5	20.1
State enterprise	8.9	9.7	6.8
In private houses	48.7	45.8	55.7

Source: Hospodarske noviny, no. 52 (1990); *Tydenik hospodarskych novin,* no. 9 (1991); Federalni statisticky urad.

There is some private property that in principle could be mortgaged. Almost half the housing stock in the CSFR is privately owned—table 16.3 shows the distribution by type of ownership and republic—and most of this housing is presently unmortgaged. Does this mean that there is a fund of property that is available for use as collateral?

The answer is rather complicated because there is a strict tenancy law that makes eviction very difficult, even in the case of foreclosure. For this reason, banks do not usually accept private apartments as collateral.[30] Cooperative apartments are also quite unsuitable as collateral.[31] However, mortgage credit can be obtained against the security of some private houses, particularly second homes in rural areas.[32] Unfortunately, it is not possible to determine whether this potential collateral is in the hands of would-be entrepreneurs.

All this evidence suggests two conclusions. First, there are no remaining barriers to private-sector growth that could be rapidly removed by government action. Second, it is unlikely that the CSFR private sector will soon amount to a large part of the economy. There are plenty of people who want to be entrepreneurs, but it is difficult for them to expand rapidly, and there are no easy answers to their problems with the credit system.

This rather pessimistic conclusion does suggest a further question. Can the process of small privatization—especially the sale of shops—help the accu-

30. There are not many such apartments, even though, according to Czech law no. 283/90 Sb., municipalities are allowed to sell state-owned apartments to private persons. The process of housing privatization has been slowed down by restitution claims.

31. According to law no. 176/90 Sb., a member of a housing cooperative can transfer his or her rights and obligations to another person, provided that the housing cooperative agrees. The second person must then become a member of the cooperative. A cooperative apartment remains always the property of the cooperative, and a person can buy and sell only the right to use it.

32. Agricultural land remains predominantly nonprivate. According to official statistics, in 1988 there were 6,749,000 hectares of land in state and cooperative farms, and only 261,000 hectares were farmed by "self-producers," i.e., private farmers. There are not yet any official statistics concerning the privatization of land, even though some land has been obtained by former members of cooperatives. Still outstanding are most claims for the restitution of land seized after the Second World War.

mulation of capital in the private sector? Can the government promote private business by helping it acquire privatized assets?[33]

The privatization of retail shops and restaurants is governed by the so-called small privatization law, number 427/90 Sb. There are no official data on the number of shops affected, and estimates range between 70,000 and 130,000 for the whole CSFR (*Banker*, no. 46 [December 1991]). Almost all privatizations take the form of an auction, sometimes for full ownership rights, more often for a two-year lease.[34] Recently, there have also been auctions of five-year leases. Around 12 percent of all sales have been through "Dutch auctions," which are intended to facilitate sales in areas where demand for retail space is not great.[35] By the end of 1991, 19,500 units had been sold or leased in the CSFR, for a combined price of Kčs 25.5 billion ($800 million) (Rutland 1992). For most types of retail shop, the new operator or owner can freely choose the goods to be sold.[36]

Until the small privatization process began at the start of 1991, there were almost no private retail shops or restaurants. Small privatization continues but will not quickly transform the structure of the economy. Quite probably, the most attractive properties were auctioned first, and the pace of small privatization will slow.

Restitution has been resolved in principle by legislation, but important practical issues remain.[37] The only property that can be claimed is that which was nationalized or confiscated after 25 February 1948.[38] Restitution will either be through returning the original property or through a combination of cash and government bonds as compensation. By September 1991, 12,000 claims under law number 87/91 had been presented to the CSFR Ministry of Finance. Under these laws, there are deadlines by which claims must be made. However, the last deadline at this time—for claims on land—is 31 December 1992, so the restitution process is far from complete.

Even if these complications with small privatization are resolved, most CSFR production and employment remains concentrated in large firms, which

33. It is up to the Federal Ministry of Finance and the Republic Ministries of Privatization whether a particular firm should be treated as large or small and dealt with under law no. 91/91 Sb. or law no. 427/90 Sb., respectively.

34. The first time a set of property rights is auctioned, only Czech and Slovak citizens are allowed to bid. Foreigners can bid at subsequent auctions if the property rights are not bought in the first round.

35. See the statement by Minister Jezek in Hospodarske *noviny*, 1 October 1991. The term *Dutch auction* is used in the CSFR to describe an auction in which the asking price starts at book value and then falls until a purchase is made or until the minimum reserve price is reached. Dutch auctions have been used in less wealthy regions; in the center of Prague, there are no Dutch auctions, and the selling price has been on average thirteen times higher than the initial asking price.

36. An important exception is food shops—for one year after an auction or restitution there cannot be a substantial change in the type of goods sold.

37. Claims can be made under laws nos. 403/90, 458/90, 87/91, 229/91, and 137/91 Sb.

38. This effectively excludes firms that were confiscated after the Second World War because the owners were deemed to have collaborated with the Nazis.

the private sector is not in a position to purchase quickly. At the same time, the so-called large privatization has been delayed and has not generated rapid success. The CSFR faces a serious problem because of the size disparity between the very young private sector and the existing state sector. It is unlikely that the private sector can provide a significant share of output, particularly in industry, for some years. Unless large state firms are broken up into small, more digestible pieces, it is also unlikely that the existing private firms will be able to purchase a significant amount of privatized assets.

16.2.2 Hungary

Given the fact that the private sector has been developing in Hungary for a relatively long period—at least since 1982 and arguably since 1968—it might be expected that Hungarian official statistics would better cover the private sector than is usual in Eastern Europe. If anything, the opposite is true. Most disappointing is that there exist almost no official data that show directly the property form of an enterprise.[39] As a result, it is extremely hard to determine what is really private and what represents some reorganized form of state enterprise in Hungary.[40]

The available statistics on the number of firms are given in table 16.4. The Hungarian Statistical Office divides firms into a number of categories, which are represented in this table. First, there are five forms of state companies: enterprises, trusts, subsidiaries, joint companies (known in Hungarian as *Kozosvallalat*), and associations (known in Hungarian as *Egyesules*). Second, there are incorporated firms, which include both joint-stock companies and limited-liability companies.[41] Third, there are various kinds of cooperatives. There are also joint ventures with foreign partners and unincorporated businesses, neither of which are included in table 16.4.[42]

The most striking fact revealed in table 16.4 is the rapid rise in the number of limited-liability companies during 1990. This rise is confirmed by numbers that are available for the end of 1990, which show 18,317 limited-liability companies and 646 joint-stock companies (*Figyelo*, no. 39 [1991]).[43] As table 16.4 shows, by the end of June 1991, there were 28,059 limited-liability companies

39. The statistical office uses the term *private* to refer to individual entrepreneurs. The actual level of private capital in a company is nowhere measured.

40. This confusion is partly due to the fact that in Hungary, particularly between 1989 and 1990, state enterprises were able to initiate "spontaneous" privatization (Stark 1990). State enterprises never had this opportunity in the CSFR.

41. As far as we know, nearly all joint-stock companies so far have been established by state enterprises, but most limited-liability companies were founded by private individuals.

42. Sometimes three types of firms—joint-stock companies, limited-liability companies, and joint ventures—are classified together as *economic companies* (known as *gazdasagi tarasago* in Hungarian).

43. *Figyelo* (Observer) is a Hungarian economic weekly.

Table 16.4 **Number of Hungarian Firms, by Institutional Form (excluding unincorporated firms)**

	Dec. 1982	Dec. 1985	Dec. 1986	Dec. 1987	Dec. 1988	Dec. 1989	Sept. 1990	Dec. 1990	May 1991
State companies									
Enterprises, trusts	1,782	1,910	1,940	1,955	1,986	2,001	2,008		
Subsidiaries	25	254	345	397	391	398	373		
Joint companies (*Kozosvallalat*)	211	251	276	302	309	327	251		187
Associations (*Egyesules*)	45	57	61	69	78	105	198		201
Incorporated firms									
Joint-stock companies	19	62	74	137	116	307	594	646	784
Limited-liability companies (KFT)	...	...	...	...	451	4,485	15,560	18,317	28,059
Cooperatives									
Agricultural fishing and specialized agricultural cooperatives	1,387	1,350	1,340	1,337	1,333	1,333	1,392		
Other cooperatives	2,745	2,735	2,719	2,658	2,439	2,510	2,559		
Small cooperatives	145	762	1,278	2,154	3,108	3,233	3,191		
Other	...	535	545	588	600	470	576		
Total	...	7,916	8,578	9,597	10,811	15,169	26,702		

All data are for the end of the respective month.

Sources: Economic Trends in Hungary (Budapest: Gazdasagkutato Intezet, November 1990), except for May 1991 data, which are from *Heti Vilaggazdasag,* 19 October 1991.

in Hungary. By the end of 1991, there were between 52,000 and 53,000 incorporated businesses in Hungary.[44]

The growth in limited-liability companies provides a rough indicator for the development of private business, although some of these "new" firms may actually be previously existing firms which were legally registered for the first time.[45] We also know that, during 1990, 14,867 "economic organizations" were "founded"—although only 13,491 were classified as being "new"—while 632 were closed and 202 reported as having no legal successor (Central Statistical Office, Monthly Statistics, July 1991). Unfortunately, this source does not indicate either the property form or the sectors of those firms that opened and closed.

There has also been a rapid growth in the number of joint ventures in Hungary—in the first nine months of 1990, 2,225 new joint ventures were established.[46] There are obvious tax advantages to forming a joint venture, although the minimum required investment is quite high—Ft 50 million (about $650,000).[47] However, there are no statistics that reveal the extent of participation by the Hungarian private sector in these joint ventures.

The number of unincorporated firms has also risen. There are two kinds of partnerships in Hungary: ordinary partnerships, in which all partners have unlimited liability, and limited partnerships, in which "full" partners have unlimited liability but any "silent" partner has limited liability. On 31 December 1989, there were 5,769 ordinary partnerships and 1,125 limited partnerships, but, by 31 May 1991, these totals had risen to 10,869 and 9,537, respectively (*Heti Vilaggazdasag*, 19 October 1991).

It is surprisingly difficult to obtain statistics on the number of individual entrepreneurs in Hungary. One estimate is that there are over 300,000 such people.[48] Another informed source states there are 500,000.[49] We have not been able to obtain satisfactory confirmation of this number, and we recommend treating it with extreme caution.

These statistics suggest that there is a boom in the creation of new business in Hungary, and it is likely that much of this business can be considered to be

44. These numbers were provided by Kalman Mizsei in his comments on this paper at the conference.

45. It is well known that there has long been a vibrant underground economy in Hungary(see, e.g., Stark 1989).

46. A joint venture can obtain a 60 percent reduction in its taxable income during its first five years, and a 40 percent reduction subsequently, provided that it satisfies the following conditions: that most of its revenue is from selling goods or running a hotel that it built; that its registered capital exceeds Ft 50 million ($650,000); and that at least 30 percent of its capital is foreign. A joint venture can receive even more generous allowances if it operates in certain "important activities," which have been established by law.

47. The official exchange rate is Ft 76.00 to $1.00. In mid-1991, the black market rate was Ft 80.00 to $1.00.

48. This figure was given by Csilla Huvyadi in a presentation at the AEA meeting in New Orleans, January 1992. We have been unable to find a published reference.

49. This number was provided by Kalman Mizsei.

private. It makes sense that Hungary's private economy should be more developed than the CSFR's, not least because Hungary's comprehensive reform legislation was initiated earlier.[50] The most important legislation was the Company Law of 1988, supported by the Law on Transformation of 1989, which made it possible to establish new forms of enterprise—such as joint-stock companies and limited-liability companies. However, the sustained growth of the Hungarian private sector can be traced back at least to the reform legislation of 1982 (Seleny 1991).

The Hungarian government's policy is clear: the private sector is viewed as an essential part of the economy and at this time should receive some advantages. Whether these advantages are sufficient remains controversial.[51] There certainly appears to be no special, comprehensive program to help the private sector.

The prerequisites for private-sector growth are arguably in place. The macroeconomic situation has sufficiently improved, and, although there is still significant inflation, there are no longer any significant shortages.[52] Foreign trade is less controlled than in the past, and imports can be made by any kind of firm or by private individuals. However, trade is not completely free. There are tariffs, and about one-third of all agricultural products still require an export licence. About 10 percent of imports are still not liberalized, including raw materials, semifinished goods, agricultural products, and some consumer goods. There are also some quotas, for example, on cars.

There is no difference in the tax rates faced by private and state firms, for example, on turnover taxes.[53] There is a 40 percent tax on profits, and the social security contribution is 43 percent of an employee's gross wage.[54] However, there are some tax advantages for private firms in the form of allowances that reduce profit-tax liability. Every firm that is owned by private individuals receives a 50 percent reduction in its profit tax, but only during 1991–93. In addition, any firm that has at least 50 percent private ownership can obtain accelerated depreciation allowances.[55] There is a 40 percent tax on profits, but private individuals instead pay personal income tax. As is apparent from table

50. The most notable pieces of recent legislation were the Company Law (no. VI, 1988), the Transformation Law (no. XIII, 1989), the Law on State Property Agency (no. VII, 1990), the Act on Securities (1990), the Preprivatization Act (no. LXXIV, 1990), the Act on Direct Foreign Investment in Hungary (1990), and the Asset Policy Guidelines (decree no. 20, 1990, of the Hungarian Parliament).

51. For example, Kornai (1990) makes a strong case for more substantial assistance to the private sector, as a way to offset the continuing strength of the state sector.

52. Hungary still imports most of its oil from the former Soviet Union, and these deliveries have been less than the agreed-on levels. Therefore, there is a potential shortage of energy that can be linked to the disintegration of the CMEA (Council for Mutual Economic Assistance) and the problems inside the former Soviet Union.

53. The turnover-tax rates for services are 0, 15, and 25 percent, and for products they are 0 and 25 percent.

54. There is an additional tax that is intended to finance unemployment benefits. Employers pay 1.5 percent of gross wages, and each employee pays 0.5 percent of his or her gross wage.

55. There are also tax breaks for "important" investments in infrastructure and agriculture.

Table 16.5 **Income Tax Rates in Hungary**

Annual Income (Ft)	Tax Rate
0–55,000	0%
55,001–90,000	12% of taxable income over Ft 55,000
90,001–120,000	Ft 4,200 plus 18% of taxable income over Ft 90,000
120,001–150,000	Ft 9,600 plus 30% of taxable income over Ft 120,000
150,001–300,000	Ft 18,600 plus 32% of taxable income over Ft 150,000
300,001–500,000	Ft 66,600 plus 40% of taxable income over Ft 300,000
500,001 and above	Ft 146,600 plus 50% of taxable income over Ft 500,000

Source: Consultant's report.

16.5, paying personal income taxes is an advantage—as long as one's income is not too far above Ft 300,000 (about $4,000). Perhaps most important, the private sector is exempt from the controls on wage growth that are strictly enforced on the state sector. This difference in tax treatment enables private firms to pay higher wages and attract skilled labor.

The state monobank was dissolved at the beginning of 1987, and five new state-owned "commercial banks" were created.[56] However, within the banking system it is evident that there are still very close ties, in the form of outstanding loans and cross-ownership, between very large state firms and banks.[57] There are fears that the Hungarian industrial structure will begin to resemble that of Yugoslavia, where banks help firms find ways to keep their budget constraints "soft." However, a counterclaim can also be made—that Hungary is following the successful German model of allowing close links between banks and firms.

In order to obtain a loan, a Hungarian entrepreneur must demonstrate that he or she has a satisfactory business plan and also provide some collateral. The one serious problem appears to be that it is very difficult to obtain mortgage credit—to borrow against the security of an apartment or a house.[58] There is also relatively little private land in Hungary.[59]

Nominal interest rates also remain quite high. In the first quarter of 1991,

56. There are no special regulations on the kind of customers that these banks should serve, but one bank has tended to specialize in lending to small enterprises.

57. This is true, even though in total the state explicitly owns only 33 percent of financial institutions (National Bank of Hungary, *Annual Report*, 1990). Some observers are worried by the rapid growth in interenterprise credits in the state sector. In early 1991, this had reached Ft 200–300 billion ($3–$5 billion), which is about 10 percent of GDP and constitutes more than half of all the loans received by enterprises.

58. The reason for the lack of mortgage credit is unclear and requires further investigation, particularly as it is possible to buy and sell private apartments freely. About 80 percent of all housing is already privately owned. In all likelihood, there are complications caused by legal restrictions on eviction—as in the CSFR and Poland.

59. The state owns 30.8 percent of the land area, and cooperatives own 57.2 percent. So-called small producers operate on only 12.0 percent of the land (annual statistics, 1989). There does not yet appear to be a well-developed market for agricultural land, so it is not yet attractive as collateral.

the interest rates on loans with a maturity of one year were between 23 and 50 percent.[60] However, inflation remains quite high—prices rose 35.7 percent in the first half of 1991.[61] Nevertheless, according to official statistics, at the start of 1990, there was Ft 374 billion ($4.7 billion) in outstanding loans to individuals and to small enterprises—with total credit of Ft 1,704 billion ($21.3 billion) (National Bank of Hungary, *Market Letter*, no. 3 [1991]). There are, in principle, also special credits available to help individuals and private firms acquire assets in the privatization process, but up to the end of 1991 these credits do not appear to have been very significant.

The privatization process in Hungary has several elements that need to be mentioned here.[62] Under the so-called preprivatization law, the State Property Agency—to which I will refer by its Hungarian acronym, AVU—plans to privatize around 10,000 shops "by 1992." This form of privatization means precisely that individuals can purchase the equipment and stocks of shops but obtain only the right to lease the real estate (*Figyelo*, 14 March 1991, 4). These rights are to be sold in open auctions, and, if successful, this would affect about 20 percent of all state-owned shops.

There are some complications. AVU has been criticized for asking too high a price for the shops. Perhaps more important, however, is that, in most cases, a successful bidder pays some money to AVU for the right to lease the property but the actual lease payments must be made to the local government. These lease payments are fixed in advance, but often for a period less than the length of the lease. Financially pressed local governments have expressed their interest in sharply raising rents on privatized shops.

In summer 1991, there began a new program, called *self-privatization*, in

60. The average annual interest rates in each month were as follows: January, 33.1 percent; February, 34.2 percent; March, 34.8 percent; April, 35.2 percent.

61. Monthly inflation was as follows: January, 7.5 percent; February, 4.9 percent; March, 3.7 percent; April, 2.4 percent; May, 2.2 percent; June, 2.1 percent (National Bank of Hungary, *Monthly Review*, no. 4 [1991]). Inflation in the consumer price index was 17.0 percent in 1989 and 28.9 percent in 1990.

62. Hungary is the only East European country in which privatization is taking place under legislation that was passed when the Communists were still in control—the Law on Protection of State Property (January 1990). Privatizations are supervised by the State Property Agency, which became operational on 1 March 1990 (Whitlock 1990).

At first, privatization in Hungary was enterprise initiated, but, after the change of political regime, there was an attempt to use more active programs, in which the government sold assets. However, by mid-1991, there was dissatisfaction with the pace of privatization (see, e.g., *Figyelo*, 11 July 1991, 1). One estimate places the value of total assets at around Ft 2,000 billion ($32 billion) (Whitlock 1990). To the middle of 1991, under AVU (the State Property Agency) there have been only 160 "transformations." (Before privatization, a state enterprise must be transformed into either a joint-stock company or a limited-liability company.) These 160 enterprises are worth Ft 203 billion ($2.34 billion), but only fifty have been fully transformed (*Figyelo*, 11 July 1991, 13).

As a result, there are new initiatives, in the form of "preprivatization" and "self-privatization," which are described in the text, as well as plans to pass a new privatization law. The precise shape of this law is not yet clear, but it seems likely to differ from Poland's, in that there will probably not be either discounts for workers in privatized enterprises or free giveaway of rights to obtain shares.

which the AVU has selected eighty-four consulting companies to act as a type of owner for up to 600 small- and medium-sized companies—with asset values less than Ft 300 million ($3.8 million) and fewer than 300 workers.[63] By December 1991, there were more than 300 contracts signed or under negotiation between AVU and consulting companies, and 132 contracts had actually been signed (*Figyelo*, 19 December 1991, 18). It is also now possible for AVU to agree to a foreign bid on an enterprise without consulting the target company.[64] Whether allowing this form of hostile takeover speeds up privatization remains to be seen.

The Hungarian restitution process remains unresolved. Legislation was passed in April 1991, but it was deemed unconstitutional by the Hungarian Supreme Court because it excluded emigrés and people whose property was taken before June 1949 from restitution. The political debate over this issue continues.

According to current Hungarian legislation, there will not be restitution of property, but people can claim compensation for property seized after 8 June 1949.[65] This compensation will be paid in the form of a government bond with a three-year maturity (par. 5 of the 1991 Law on Compensation). This bond can be turned into a lifetime annuity or used to buy privatized property, such as farmland, apartments, and AVU privatized property. Trading these bonds on a secondary market is also permitted, but anyone other than the original bondholder can use the bond only to buy property privatized by AVU. Needless to say, the precise outcome of this process is still unclear.[66]

Although statistical problems make it hard to know the precise situation of the Hungarian private sector, there are indications that its growth has accelerated in the past two years. The incorporated private business sector has grown particularly fast. Unfortunately, there are no good numbers on private-sector employment, and estimates depend greatly on the number of workers employed by registered entrepreneurs. Our best guess is that the private sector employs between 650,000 and 1 million people, which implies that its share of urban employment is in the range of 15–25 percent. The future growth of

63. Some of these consulting companies are foreign, but all must be registered in Hungary. These companies must pay a fee to the government and leave the existing management in place, and they cannot simply liquidate the firm. Their goal is to sell the firm to the highest bidder, and they will receive a percentage share of the proceeds. However, the sale must take place within two years, or the asset will revert back to AVU. Hungarians refer to this as *privatizing privatization*, and the attractions of this approach are evident when one considers that AVU employs fewer than 100 people.

64. The first such case was that of the Gundel Hotel.

65. Under the Compensation Law, the maximum amount that a person can receive is Ft 5 million ($62,500) per piece of property (par. 4.3 of the law). Restitution remains very controversial—the Smallholders' party continues to campaign on behalf of former landowners. Some important opposition groups are against restitution.

66. This process is governed by law no. 25, 1991, which was only passed in September 1991. Claims must be submitted within ninety days of the law coming into force.

this sector is likely to be steady, with probably a slowdown in the rate of creation of new businesses.

16.2.3 Poland

Statistics on the number of firms in the Polish private sector are quite good.[67] However, in order fully to understand these statistics, it is necessary to appreciate the difference between *trade law companies* and *individuals* who operate as firms. Both limited-liability and joint-stock companies are trade law companies, which means that they have their legal basis in the amended 1934 Commercial Code.[68] In this paper, I refer to these companies by their common collective Polish name: *spolka*. Polish official statistics define a *spolka* as private when at least 51 percent is owned by private individuals, and table 16.6 shows the recent rapid growth in the number of private *spolki*.

Table 16.6 shows both companies founded with only "domestic" capital and those that were registered as joint ventures—at this time requiring a minimum investment of $50,000 in "hard currency."[69] The total number of joint ventures rose from 32 in 1988 to 429 in 1989 and 1,645 by the end of 1990. For most of the Communist period, it was not practically possible to create new *spolki*, but this changed after 1987 when the Communists tried to encourage some private business.[70] The number of incorporated *spolki* rose from 1,275 in 1988 to 11,693 at the end of 1989 and to 33,239 at the end of 1990.

The growth of *spolki* tells only part of the story of the Polish private sector. Many private entrepreneurs, even those with substantial businesses, prefer to operate as individuals.[71] There are several reasons for this. First, it takes only a few days to start an individual business because it is necessary only to complete a simple registration procedure; in contrast, forming a *spolka* is relatively complex and usually takes time.[72] Second, there is no minimum starting capital for an individual, whereas for *spolki* it is now Zl 10 million (about $1,000) for a limited-liability company and Zl 250 million (about $20,000) for a joint-

67. In the Polish statistical system, a company with at least 51 percent of its shares privately owned is defined as private.

68. A very good translation of the Commercial Code is now available: "The Polish Commercial Code: The Law as at 15th August 1991," translated by Roman Poplawski and published by the Polish Bar Foundation (Warsaw, 1991).

69. Not shown in table 16.6 is the number of *Polonia* firms, which were a forerunner of joint ventures in which only foreigners of Polish origin were supposed to participate. Although these firms attracted some attention when first formed, they were never a very significant part of the economy. *Polonia* firms numbered 46 in 1980, 683 in 1985, 689 in 1988, 727 in 1989, and 862 in 1990.

70. A few *spolki* existed under the Communists, but these had been created before the Communists took power, and they were subject to state control.

71. De jure, one principle advantage of *spolki* is that they have limited liability. However, interviews with entrepreneurs suggest that, in practice, individuals do not face unlimited liability.

72. A *spolka z.o.o.* (limited liability company) can be formed in a few weeks, but a *spolka akcyjne* (joint-stock company) takes significantly longer.

Table 16.6 The Number of Private *Spolki* in Poland: Domestic and Joint Venture

	31 December 1989	1 December 1990	30 June 1991
Industry			
Domestic	2,769	7,014	7,698
Joint venture	240	853	1,431
Construction			
Domestic	2,640	5,646	7,164
Joint venture	12	71	167
Agriculture			
Domestic	83	342	285
Joint venture	14	48	62
Forestry			
Domestic	10	36	39
Joint venture	3	4	5
Transportation			
Domestic	86	356	507
Joint venture	14	67	124
Telecommunication			
Domestic	18	56	80
Joint venture	. . .	5	7
Trade			
Domestic	1,759	8,661	12,598
Joint venture	32	198	475
Other branches of material production			
Domestic	2,979	7,098	5,837
Joint venture	80	258	296
Municipal economy			
Domestic	76	160	163
Joint venture	1	6	9
Nonmaterial production			
Domestic	1,273	3,870	4,145
Joint venture	33	135	264
Total	11,693	33,239	38,516
Of which, joint venture	429	1,645	2,840

Source: Consultant's report.

stock company.[73] Third, if the accounting is handled properly, there are fewer taxes on an individual entrepreneur than on a *spolka* (see below for more de-

73. Up to 1989, the minimum capital required to start a limited-liability company was Zl 1,000, which had been a significant amount in the 1930s but was worth only a few dollars by the late 1980s. It is not unusual to meet people who registered several *spolki* at that time, some of which may still be "sleeping"—if they are not active, then no taxes need to be paid.

Table 16.7 **Number of "Individual Entrepreneurs" in Poland**

	31 December 1990	30 June 1991	30 September 1991
Industry	334,613	339,291	348,803
Construction	165,541	165,428	170,618
Transportation	61,368	56,913	60,203
Trade	346,294	456,844	N.A.
Catering and restaurants	22,511	30,443	N.A.
Other material services	122,099	122,555	124,768
Nonmaterial services	83,066	100,923	111,629
Total	1,135,492	1,272,397	N.A.

Source: Consultant's report, based on statistics from the Polish Central Statistical Office.
Note: N.A. = not available.

tails). In addition, there was a one-year tax holiday that was available to individuals in 1990, as long as they were "newly" involved in wholesale trade.[74]

On 31 December 1989, official statistics reveal that there were 813,485 "unincorporated firms" registered, of which 482,020 were in handicrafts, 71,802 were in trade, and 259,663 were classified as *others.*[75] Fortunately, after this date, statistical information was published in a more detailed form, and table 16.7 shows the number of unincorporated firms (also known as *individual entrepreneurs*) at the end of 1990, halfway through 1991, and—for some sectors—at the end of the third quarter of 1991.

Table 16.7 shows growth, but perhaps not as rapid as might be expected—anyone who has visited Warsaw in the last two years can attest to the number of new firms that are apparent. In fact, as table 16.8 shows in some detail, during 1990 there were significant numbers of start-ups and liquidations of private firms.[76]

Some of these firms failed because, although they had prospered under the Communists, they could not adapt to the completely new economic conditions in 1990. For example, the category *handicrafts* represents mostly traditional private-sector activities, which were allowed to operate under the Communists. The "net balance" of firm creation in this sector—start-ups minus suspensions

74. The actual requirement was that the business was new at the address where it was registered. Not surprisingly, there is anecdotal evidence of businesses simply changing their addresses and people active in other sectors—especially retail trade—switching to be registered as wholesale traders.

75. Official statistics give the total number of unincorporated firms as 357,000 at the end of 1980, 418,000 at the end of 1985, 660,000 at the end of 1988, 814,000 at the end of 1989, and 1,136,000 at the end of 1990.

76. A suspended firm does not have to pay taxes but can be quickly reestablished. In interviews, entrepreneurs sometimes say that they currently operate one firm but that they have several more "sleeping." Some sleeping firms can be viewed as a form of tradable option. For example, in 1991, I was offered a sleeping firm that was exempt from taxation—because it had been properly registered as a wholesale trader before the end of 1990. Unfortunately, official statistics do not appear to record the number of sleeping firms that are reawakened.

Table 16.8 Start-Up, Liquidation, and Suspension of "Individual Firms" during 1990 in Poland

	Cumulative Totals, in Thousands (by quarter)			
	1–3	1–6	1–9	1–12
Total				
Start-up	66.9	174.7	314.1	516.2
Liquidation	33.7	65.6	102.0	154.0
Suspension	78.3	81.4	93.4	100.2
Handicraft				
Start-up	26.5	54.5	85.7	140.6
Liquidation	19.4	36.4	53.1	75.0
Suspension	42.4	43.5	46.2	51.1
Trade				
Start-up	27.3	91.0	180.9	300.7
Liquidation	4.4	10.9	22.5	41.9
Suspension	6.0	8.6	16.4	21.4
Services				
Start-up	13.1	29.2	47.5	74.9
Liquidation	9.9	18.3	26.4	37.1
Suspension	29.9	29.3	30.8	27.7

Source: Consultant's report, based on statistics from the Polish Central Statistical Office.

and liquidations—was negative in the first three quarters of 1990. The most striking contrast is with the trade sector, which is composed largely of entrepreneurs who entered this activity in 1989 and 1990. Table 16.8 shows a positive net balance of firm creation for this sector even in the first quarter of 1990, and this net balance rose rapidly during 1990.

The latest available data are for 30 September 1991, and they show totals of 44,226 private *spolki*, 3,512 joint ventures, and 1,365,644 individual entrepreneurs. Table 16.9 shows the sectoral composition of the individual entrepreneurs' activity, their employment; it also shows that about 200,000 of these firms have managed to qualify for tax-free status. The latest estimates are that the private *spolki* and joint ventures together employ 0.5 million people, in addition to the 2.5 million shown employed by individual entrepreneurs in table 16.9. The Polish urban labor force is about 12 million people, so these numbers imply that the private sector accounts for 25 percent of jobs outside agriculture.

This private-sector growth was not the result of particularly favorable government tax policies. In fact, Polish tax policies are very similar to those of the CSFR. Private firms face the same turnover and social security taxes as state firms. *Spolki* face a corporate income tax of 40 percent, although the effective

Table 16.9 **Number of Individual Entrepreneurs in Poland on 30 September 1991**

	No. of Firms		
Sector	Total	Of Which, Taxed	Total Employment
Industry	348,803	306,989	826,658
Construction	170,618	154,430	392,575
Transportation	60,203	59,493	74,575
Trade	514,778	393,838	797,772
Catering	34,845	29,973	83,981
Material services	124,768	122,353	143,953
Nonmaterial services	111,629	102,443	159,552
	1,365,644	1,169,519	2,477,751

Source: Consultant's report, based on statistics from the Polish Central Statistical Office.
Note: The second column shows the number of firms that were actually subject to taxation.

tax rate may be much lower.[77] State firms also pay 40 percent corporate income tax, but they are liable to two important taxes from which the private sector is exempt. First, there is the "excess wage tax," which penalizes firms paying wages above a norm set by the government.[78] Second, state enterprises must also pay a "dividend" to the government, based on the value of their fixed assets.

Individuals operating as a business must pay income tax and also a "leveling tax"—if the entrepreneur's annual income exceeds Zl 36 million ($3,000). The Polish tax rates are quite high, as can be seen from table 16.10.[79] In addition, the entrepreneur must pay a 20 percent "wages tax" and a social insurance contribution that is at least Zl 238,000 per month.[80]

Surprisingly, some strange Communist tax regulations still exist with regard to individuals operating in the "handicrafts" sector. For this sector, there is also a fixed tax per year, with a rate that depends positively on the size of the town in which the firm operates. The tax also depends on the number of employees—a tailor who works by himself in a town with more than 50,000 inhabit-

77. Polish entrepreneurs have found numerous ways to reduce their tax liability. One favored route is to have several companies, which employ each other as subcontractors and thus reduce their declared profit.

78. In 1990, there were bitter complaints from the private sector when it was subject to the same "excess wage tax" as the state sector. Private firms were fully exempted from this tax only in 1991, but anecdotal evidence suggests that they found ways to avoid it even in 1990.

79. A new, comprehensive income-tax system is supposed to have come into operation on 1 January 1992, but essential details are still not clear.

80. For example, a person earning Zl 36,000,000 (about $3,000) would be exempt from the leveling tax but would pay 20 percent income tax and at least 8 percent (Zl 2,856,000, about $260) in annual social insurance contribution. This implies an effective tax rate on private entrepreneurs of around 28 percent.

Table 16.10 Tax Rates for Individuals in Poland

Income (Zl)	Tax Rate
Income tax	
0–26,400,000	20%
26,400,000–52,800,000	Zl 5,280,000 plus 30% of taxable income over Zl 26,400,000
52,800,000 and over	Zl 13,200,000 plus 40% of taxable income over Zl 52,800,000
Leveling tax	
36,000,000–54,000,000	10% of taxable income over Zl 36,000,000
54,000,000–72,000,000	Zl 1,800,000 plus 20% of taxable income over Zl 54,000,000
72,000,000–90,000,000	Zl 5,400,000 plus 30% of taxable income over Zl 72,000,000
90,000,000 and over	Zl 10,800,000 plus 40% of taxable income over Zl 90,000,000

Source: Consultant's report.

Note: There are about Zl 11,000 to $1.00.

[a]Income up to Zl 36,000,000 per year (and per partner where appropriate) is exempt from the leveling tax.

ants must pay Zl 61,000 ($5.00) per month, whereas a neighboring tailor with five employees should pay Zl 858,000 ($78.00) per month.[81]

In the second half of 1990, there was a one-year tax holiday available to individuals in wholesale trade, but one of its main effects seems to have been to induce reregistration of already-existing firms. There were also some individual firms, created in September 1990, that were able to avoid paying customs duty.[82] Owing to a complicated legal situation, some wholesale trade companies opened in September and October 1990 are exempt from customs duties.[83]

There were some significant tax changes during 1991, which included allowing losses from one year to be included in costs for up to three years. There was also an increase in amortization allowances. However, more important, it remains possible to include almost all investment as a cost of production, as long as it can be bought in units costing less than Zl 1,000,000 (about $100).[84] For this reason, leasing is a popular method of obtaining capital equipment.

Turnover tax is currently 20 percent for production activities, 5 percent on trade, and 5 percent on services. However, there is a special turnover tax on imported goods that must be paid on the border. For some goods, state importers are able to pay lower tax rates than private importers.[85] There are strange

81. For example, the monthly fixed tax on a hairdresser with no employees is Zl 49,000 in towns with a population up to 5,000 people, Zl 55,000 if the population is between 5,000 and 50,000, and Zl 61,000 if the population exceeds 50,000.

82. This was the result of a very complicated legal situation.

83. Advertisements have appeared in newspapers that say something along these lines: "I have a company opened in September 1990, and I am looking for proposals."

84. For example, if you want a new set of office furniture, it is best to buy each chair separately.

85. For example, at the end of 1989, a private importer of gasoline paid a tariff of 40 percent, while a state importer only paid 20 percent.

anomalies in the turnover-tax system. For example, there is a 15 percent turnover tax on imported paper, but no turnover tax on imported books.

It is also readily apparent that the Polish banking system did not play a major role in private-sector development. The monobank was broken up at the beginning of 1989 and divided into nine commercial banks, each of which had a regional basis.[86] At least fifty private banks were created, but these remain very small. In December 1990, state banks were responsible for at least 97 percent of all credits.[87]

These banks are extremely inefficient in their transfer of money, particularly in and out of Poland. Simple transactions can take several weeks or even months. Many private importers who rely on a rapid turnover of goods have had to devise ways to send large sums of cash out of the country. Regulation of banking activities has also been unsatisfactory—this was most evident in the "Art-B" scandal of the summer of 1991, which resulted in the dismissal of the president of the National Bank of Poland and the arrest of the senior vice-president.[88]

Unfortunately, government credit policy has also not been able to help the private sector. Faced with an inflation rate that remained stubbornly high, the government has had to maintain quite high nominal interest rates. The benchmark National Bank of Poland refinance rate peaked at 432 percent per year in January 1990 and then fell steadily to 34 percent in June 1990. However, it rose again from October 1990 to February 1991, reaching 72 percent per year. By October 1991, it was down to 40 percent. Loan rates were usually about one-fifth higher than the refinance rate.

Calculating real interest rates when both nominal rates and inflation are high is difficult, but the following general conclusions are possible. Very high inflation meant negative real interest rates at the beginning of 1990, at the same time as nominal rates were shockingly high. In June 1990, monthly inflation was down to 3.4 percent (equivalent to 49 percent per year). Monthly inflation has remained in the 2–6 percent range since that time (annualized rates of 27–100 percent), which means that the real interest rate moves from positive to negative from month to month.

It seems likely the continued high level of nominal interest rates, combined with instability in the real rate, discourages private borrowing. Credits for private firms and individuals were 17 percent of total bank credits on 31 March 1991 and 21 percent on 30 September 1991. There is also anecdotal evidence

86. There are also six specialist banks, e.g., one for food processing and another for the financing of foreign trade.

87. There are plans to privatize these commercial banks, probably beginning with Bank Slaski and Bank Wielkopolski.

88. Art-B might be the only private firm that has benefited from the inefficiency of the Polish banking system. Art-B shifted money between banks rapidly in order to earn interest at several banks simultaneously—this mechanism is referred to in Polish as an *oscylator*. It was also able to obtain a large amount in bank loans that were not properly secured. The owners of this company subsequently escaped the country.

Table 16.11 **Ownership of Polish Housing Stock (% shares)**

	Cooperatives	State Enterprises	State	Private
Total	24.3	12.1	19.3	41.7
Urban	36.7	11.4	27.7	23.4
Rural	.5	13.5	3.1	76.7

Source: Statistical Yearbook, 1988.

of an informal market for loans in hard currency, which have the advantage of carrying a low, stable rate of interest.

Especially after the recent Art-B scandal, banks have become very cautious about lending to private firms and often require more than 100 percent security in the form of liquid assets—such as bank deposits. There is some available collateral in the hands of the private sector, principally housing. As table 16.11 shows, the private sector owns more than three-quarters of housing in the countryside and almost one-quarter in towns. In addition, these data are from 1988, and since that time some people have bought their cooperative apartments. Unfortunately, official housing statistics have become increasingly unreliable because, although it is permitted to buy and sell private and cooperative apartments, there are legal restrictions and tax regulations, which means that a great deal of this activity takes place in a disguised form.[89] Probably another 10 percent of the urban housing stock has become private through some form of market transaction. However, this progress should not be confused with plans to privatize "state" housing—controlled by local government—which have not yet produced significant results.

It is possible to borrow against the security of a private apartment, but banks require that no one other than the owner is registered as living there. This form of credit is easier to obtain in the countryside, but it still requires a lot of administrative work, and the property must be properly evaluated. State banks apparently do not welcome this kind of work.

Most agricultural land is privately owned. Official statistics for 1990 show individuals owning 76 percent of arable land, with state farms owning 18.6 percent and cooperatives having 3.7 percent. More than 3.5 million people work on private farms, while around 800,000 work on state and cooperative farms.

There has been some privatization of state assets, which has helped private-sector development. Efforts to sell state enterprises in auctions have definitely not been very successful. Instead, privatization by "liquidation" has been more widespread—by December 1991, at least 875 firms had undergone this pro-

89. The main problem is how to minimize the sales tax when an apartment changes hands. Various techniques are employed, including using fictitious names and "exchanging" apartments rather than selling.

cess, which usually means that they end up being owned by their employees. The employees have to provide 20 percent of the firm as a down payment and can buy the rest of the firm from the state in installments. However, these firms are relatively small, and the total amount of privatized firms so far probably accounts for no more than 5 percent of total assets of state firms.

The privatization of retail space has proceeded much more smoothly. Under the Communist regime, a large number of shops were in principle privately owned but in practice controlled by a state agency of some kind. Early in 1990, private owners were able to regain this property. In addition, from May 1990, newly elected non-Communist municipalities had the right to dispose of shops that had been state owned. Most of these municipalities were short of money, and this encouraged them to auction off the movable property of shops quickly, along with fairly short-term leases for the building—usually the leases are for a few years.[90] By the end of 1990, private firms operated 65 percent of all shops but only 27 percent of total retail space—some large cooperative and state stores remain. However, after the first six months of 1991, 75 percent of shops were privately run, and this accounted for 80 percent of retail sales. The total number of private shops in mid-1991 was 456,000, up from 346,300 a year before.

Although most agricultural land remained private during communism in Poland, there was substantial nationalization of urban property.[91] The situation with regard to reprivatization remains unclear, and there is not yet definitive legislation on this point.[92] However, it is relatively simple to recover property that was taken illegally by the Communists—that is, in breach of the Communists' own laws. Typical types of property are mills, buildings, land, and drugstores.

The Polish private sector appears to be doing well, although some problems definitely remain. Taxes are high, credit conditions are unfavorable, and privatization has been quite slow. Nevertheless, there continues to be rapid growth both in the number of private firms, incorporated and unincorporated, and in private-sector employment.

16.2.4 Comparison

In order to compare the relative importance of private-sector activity, table 16.12 gives data for estimated urban labor forces: 4 million in Hungary, 7 million in the CSFR, and 12 million in Poland. We use this measure rather than total population as the basis for comparison because around one-quarter of the Polish work force is in agriculture—the average total employment in Poland in 1990 was 16.5 million, but employment in agriculture accounted for 4.4

90. There have been complaints that municipal authorities raise rents repeatedly even when this is not allowed under the lease.

91. One estimate is that 20,740 enterprises were nationalized in the period 1945–59.

92. There remains debate about whether the 1946 Nationalization Act should be accepted as legitimate.

Table 16.12 Comparison of Current Government Prices

	CSFR	Hungary	Poland
General indicators			
Population (million)	16	10	38
Labor force (urban) (million)	7	4	12
No. of private firms:			
Incorporated	5,000	50,000	40,000
Unincorporated (million)	1.1	.4–.5	1.5
Sectors of private activity (% of registered entrepreneurs in a sector)			
Industry (%)	2–28	N.A.	26
Trade (%)	17	N.A.	38
Equal legal treatment?	Yes	Yes	Yes
Macroeconomic situation:			
Substantial convertibility	Yes	Yes	Yes
Black market premium	5%	5%	No
Liberal trade	Mostly	Mostly	Mostly
Shortages	No	No	No
Taxes			
Tax rates (%)			
Corporate income	20–55	40	40
Private income (see also	15[a]	4[a]	20[a]
table 16.13)	55[b]	50[b]	80[b]
Turnover	0, 11, 20, 29	0, 15, 25	5, 20
Social security tax (%)	8.7	43	45
Wage tax (per employee) (%)	50	. . .	20
Excess wage tax	Yes[c]	No[d]	No[d]
Tax advantages for private sector:			
Accelerated depreciation	Yes[e]	Yes	Yes[f]
Carry-forward losses	No	No?	Yes[f]
Tax credits	No	Yes	
Tariffs	15%[g]	Various	0%–40%[h]
Capital needed for limited liability	$3,000	$15,000	$1,000
Tax advantages for joint ventures	Yes	Yes	Yes
Minimum capital required for joint venture	Kčs 100,000 ($3,300)	Ft 50 million ($650,000)	$50,000[i]
Credit situation			
Dominant state banks?	Yes	Yes	Yes
Preferential interest rates?	No	No	No
Nominal interest rates in 1991 (%)	20	20–50	40–70
Inflation 1991 (%)	50	35	30–100
Private share of total credit (%)	< 5	25	< 21
Private housing (% share of total)	45	N.A.	40

Table 16.12 (continued)

	CSFR	Hungary	Poland
Privatization progress			
Large companies	Begins in spring 1992	Under way and gradual	Repeated delays
% privatized at end of 1991	A few[j]	10%[k]/25%[l]	< 10%
Shops and restaurants privatized (% of total numbers)	10	10	60–80
Restitution:			
Laws passed	Yes	Yes	No
Politics settled	Yes	No	No
Claims settled	No	No	No

Sources: Discussed in text and other tables.
Note: N.A. = not available.
[a]To $1,000
[b]Top rate.
[c]200%–750%, but not if small.
[d]Yes for state-owned enterprises.
[e]Restricted.
[f]Recent.
[g]Many exceptions.
[h]Usually.
[i]Valued in dollars.
[j]Foreign deals.
[k]Fully.
[l]Corporatized.

million (*Rocznik Statystyczny 1991*, p. 93, table 2 [174]). The fraction of labor working in Hungarian and CSFR agriculture is much lower.

In terms of the number of incorporated private businesses, Hungary clearly has the lead, with 1.3 incorporated businesses per 100 people in the urban labor force, while Poland has 0.3 and the CSFR only 0.1. But, in terms of the relative number of unincorporated businesses, the CSFR surprisingly has the lead, with 16 such firms per 100, while both Poland and Hungary have 13. However, we suspect that a large number of registered entrepreneurs in the CSFR are actually working for other people and declaring themselves to be self-employed as a way to avoid the wage tax. Unfortunately, it is very hard to know how much these different private sectors contribute to national output. One set of estimates for the share of the private sector in GDP is 14.7 percent for Poland, 16.6 percent for Hungary, and 3.1 percent for the CSFR (Brandsma 1991).[93] In terms of share in urban employment, we estimate that, in both Poland and Hungary, the private sector now provides 20–25 percent while, in the CSFR, it accounts for less than 5 percent.[94]

93. This same source estimates that the private sector contributes to GDP 8.9 percent in Bulgaria, 3.5 percent in the former East Germany, 2.5 percent in Romania, and 2.5 percent in the former Soviet Union.

94. Although it is not directly comparable to Eastern Europe's private sector, we should note that the small business sector in Western Europe contributes between 32 percent (in the United Kingdom) and 46 percent (in Germany) to GNP.

Our conclusion is that, compared to the CSFR, and implicitly to other post-Communist countries, the private sector is relatively strong in both Hungary and Poland. However, this strength is manifest differently in the two countries. We therefore have two phenomena to explain. First, why are Hungary and Poland ahead of the CSFR in terms of private-sector development? Second, why has the private sector in Hungary developed in a corporate form, whereas in Poland a much larger part is unincorporated?

Table 16.12 summarizes the different measures of government policy that were discussed above. With regard to macroeconomic policy and basic legal framework, all three countries are very similar. For example, all have substantially liberalized trade while still having—at the end of 1991—some trade restrictions. In all three countries, private business is now subject to a commercial code that draws heavily on the German-Austrian model and that is related to their prewar experiences.

Government tax policy cannot really explain the differences between these three countries. As table 16.12 shows, corporate income tax rates in all three countries are remarkably similar. Table 16.13 provides a comparison of the rates of taxation on individual entrepreneurs—we calculated the rate of tax that an individual must pay at various levels of income, converted into dollars. Table 16.13 suggests that tax rates are highest at all income levels in Poland, lowest for low incomes in Hungary, and lowest for mid-range incomes ($3,000-$5,000) in the CSFR. Of course, table 16.13 does not reflect other tax legislation, such as accelerated depreciation and the ability to deduct business expenses from taxable income. As we discussed above, it seems easiest to reduce taxable income in Poland and hardest in the CSFR—although the CSFR tax code is currently being revised to allow more deductions. Nevertheless, table 16.13 suggests the interesting conclusion that the Polish registered entrepreneurs have prospered, not because of favorable tax rates, but despite very high rates.

In terms of credit conditions, as measured by nominal and real rates of interest, it appears that the CSFR had an advantage, in the form of low real interest rates, during the first half of 1990, but now its real rates are very high. Unfortunately, we could not obtain information about the extent of credit rationing to private firms, and this may be more important than the posted lending rate. Hungary may have the best combination—nominal interest rates roughly in line with inflation and an established pattern of lending by some state banks to private firms. The continued instability of real and nominal zloty interest rates in Poland should probably be considered a major disadvantage.

Small privatization appears to be proceeding significantly faster in Poland than in either the CSFR or Hungary. This may be because there is not much capital in the hands of private business in the CSFR and because the auction process has been centrally controlled in Hungary. However, in our opinion, the successful auction of leases to shops is an effect rather than a cause of the strong Polish private sector.

Table 16.13 Comparative Income-Tax Rates

	Effective Tax Rate (%)		
Income per Year in U.S. Dollars	CSFR	Hungary	Poland
1,000	15	4	20
3,000	18	20	22
5,000	21	27	32
10,000	27	37	50
Top rate	55	50	80

Source: Author's calculations based on tables 16.1, 16.5, and 16.10.
Note: We used approximate exchange rates of Ft 80.00/$1.00, Kčs 29.00/$1.00, and Zl 11,000/$1.00.

Our comparative evidence has raised an important question. Why has the private sector been relatively successful in Poland? Economic reform in Poland began more recently than in Hungary and brought with it high inflation and other macroeconomic problems. How did the Polish private sector manage to grow in this environment? Is there something different about the Polish private sector?

16.2.5 What Is Different about Poland?

Why has the Polish private sector done relatively well in its unusual, unincorporated form? In our opinion, the answer lies in the way the Polish economy was reformed. The Polish private sector is the product of a particular sequence of events, primarily due to changing government policy.

The relaxation of controls over the private sector came earlier in Poland than in the CSFR. It is true that the new wave of *spolki* creation did not really begin until 1988, but since the mid-1980s there had been gradual liberalization of private economic activity—for example, at this time new cooperatives were created that were essentially private firms (Johnson and Loveman 1993).[95] There was a rapid growth in individual international trade by Poles—the government did not impose any restrictions on most people's travel.[96] In fact, it was quite common for young Poles to work in Western Europe for a few months each year.[97] Foreign travel was much harder for Hungarians and citizens of Czechoslovakia.

These experiences matter because it was in these small ways that Poles learned about nonstate business, acquired modest amounts of capital,and made connections with the outside world. Most important, it was possible to earn

95. Some of these firms were linked to the Solidarity movement, which at this time was illegal and "underground."

96. The government did restrict travel—usually by denying a passport—to people whom it regarded as its political enemies.

97. It is not uncommon to find well-educated people who worked as manual laborers at harvest time in France or Sweden.

very high rates of return on some imports. The best example is the case of computers, in which people could begin by buying computer equipment by mail order from abroad at a cost of a few hundred or thousand dollars, sell this equipment to state firms at prices that implied a return of several hundred percent, and by reinvesting in other computer-related imports accumulate—within a few years—hundreds of thousands of dollars.[98] There was a rapid accumulation of capital, both financial and human, that was unique to Poland.

The Communists also tried to rebuild some legitimacy by widening the scope of private-sector activity. In particular, the last Communist government—headed by Mieczyslaw Rakowski—passed legislation that by early 1989 had essentially removed all legal and most administrative barriers on the private sector.

However, these changes brought little in terms of visible benefits while the Communists retained power. Their macroeconomic policy was very unsuccessful and caused rapid inflation despite partial price controls.[99] The result was terrible shortages and grossly distorted prices (Lipton and Sachs 1990), a situation that exacerbated the supply problems of the private sector. Circumventing import controls helped private businesspeople make money on semilegal trade, but these controls constrained the speed with which this trade could develop.

The details of the political transformation and the construction of the economic reform of 1990 have been explored at length in other papers, and the main results are clear. Almost overnight, there was an end to shortages, and the zloty became convertible at a stable exchange rate.[100] It became possible to import freely, and private traders moved rapidly to do just that.

Two points are important. The first is that the reform program did not have to change much in terms of the legal treatment of the private sector. The most important steps had already been taken. Second, the stabilization of the economy and rapid liberalization of foreign trade had a major stimulative effect on the private sector.

As table 16.8 above shows, not all the private sector was favorably affected, and many firms that had prospered under the previous price system found themselves unable to survive at world prices. It is also true that the first quarter of 1990 showed only limited private-sector growth. But this growth soon became apparent—table 16.8 shows that the total net balance of individual firm creation improved every quarter in 1990.

98. The story of Polish computers is the subject of ongoing research by Piotr Strzalkowski and Simon Johnson.

99. For a model of the acceleration of Polish inflation, see Johnson (1991).

100. Strictly speaking, the zloty became convertible for legal persons only on current account—in order to obtain foreign currency, they had to present a valid invoice from a foreign exporter. However, the zloty was fully convertible for private persons at legal, private exchange offices (*kantors*).

16.3 Field Research

16.3.1 Methodology

It is very hard to provide a full explanation for the relatively rapid growth of the Polish private sector. However, the characteristics of Polish firms that have had some success may shed some light on this issue. Unfortunately, to this time these characteristics have nowhere been carefully measured. There are anecdotes, analyses of clusters of successful firms (e.g., Johnson and Loveman 1993), and some surveys of private firms that are based on samples that are biased—in the sense that they oversample firms that are doing badly. (These surveys cannot yet be cited.)

For this reason, we decided to collect our own primary data by interviewing private-sector entrepreneurs. In particular, we wanted to interview a representative sample of "active" firms.[101] We emphasize the word *active* because in Poland there are many registered firms that exist only on paper and that can hardly be considered the basis for sustained private-sector development.[102] The easiest way to construct a sample is to obtain a list of limited-liability and joint-stock companies because these must be registered with a court.[103] However, this would have implied ignoring those large and successful Polish private firms that, because of tax incentives, had registered as individuals engaged in wholesale trade in 1990.

Our personal experience with Polish entrepreneurs suggests that they select the property form that has the most favorable tax conditions at the time of start-up and that, if tax incentives switch, they are willing to reregister their firms. For these reasons, we decided not to use property form as a selection criterion for inclusion of firms in the sample. However, this created another problem—the population of Polish firms contains an enormous number of private individuals who have very small operations, and we did not wish these observations to dominate our sample.

For this reason, we chose to draw our sample from a very specific population—private Polish firms that advertise. In our opinion, firms that advertise are likely to be active. The details of how we obtained information on this population is contained in the appendix, which also describes how we divided our sample by sector of activity and ensured that our sample had the same

101. A short while ago, Polish entrepreneurs were unwilling to speak with outsiders. This situation changed at the beginning of the economic reform program. A good example is that, in 1990, the Central Statistical Office suddenly found that entrepreneurs became much more willing to respond to requests for information, and some also sent in long letters of comments.

102. For example, there are about 130,000 companies in Warsaw, a city with a population of around 1.8 million. This ratio of 7 companies per 100 inhabitants is rather high—the usual number in a Western city is around 4. However, many of these Polish firms do not operate on a regular basis.

103. This was the method used in one large study whose results we have read but that we are not yet allowed to cite.

Table 16.14 Survey of Private Companies in Warsaw, December 1991: Breakdown of the 294 Interviewed Private Companies, by Sector

Traditional services (mainly handicrafts)	60
Modern services (e.g., consulting, advertising, accounting, finance)	40
Production	85
Transport	8
Restaurants	4
Retail trade	20
Wholesale trade	76
Total	294

proportion in each sector as existed in the economy as a whole. Table 16.14 shows the sectoral composition of firms in our sample.

Selected firms were interviewed using a questionnaire with fifty-six questions, focusing on five sets of issues, each of which examines an important aspect of the firms' operations. We asked about several measures of the firms' size, the career of the entrepreneur, the sources of finance for this business, indicators of business strategy, and perceptions of the general economic environment in Poland.

16.3.2 Results

Because of space limitations, we provide here only some principal, overall results of our survey. More detailed results, broken down by sector, are under preparation for a separate paper.[104] For this paper, we have divided up responses between four tables, and we do not show answers to all questions, only those that most closely address the issues raised in this paper. The order in which responses are given is not necessarily the same as the order in which questions were asked.[105]

Table 16.15 shows several indicators of firm size that we chose to use. Most of the firms in our sample are quite small in terms of employment—only forty-three employ more than twenty people. At the same time, sixty-nine firms had turnover above Zl 1,000 million ($100,000) in 1990—a significant amount under Polish conditions. In almost all sampled firms, turnover was higher in 1991 than in 1990, although this is hard to evaluate because there was also substantial inflation during both years. In terms of profitability, there are really two poles: in both 1990 and 1991, sixty to seventy firms earned less than Zl 50

104. These sectors were constructed by Piotr Strzalkowski of MCR Research from his data base, in which there are seventy-six categories.

105. For example, previous experience of MCR Research suggested that entrepreneurs would answer questions about their finances, but only if they were asked after the interview was well under way—so they had already built a relationship with the interviewer. This idea appears to be confirmed by our results—a surprising number of entrepreneurs answered our financial questions very precisely.

Table 16.15 Descriptive Information for Sample

How many employees do you have?
- 0–2 (81 cases)
- 3–5 (78 cases)
- 6–20 (92 cases)
- More than 20 (43 cases)

What was your turnover in 1990 (in millions of zloty, with about Zl 10,000/$1.00)?
- Up to 100 (48 cases)
- 100–200 (18 cases)
- 200–500 (29 cases)
- 500–1,000 (28 cases)
- 1,000–10,000 (44 cases)
- 10,000–100,000 (21 cases)
- More than 100,000 (4 cases)

What was your turnover in 1991 (in millions of zloty, with about Zl 11,000/$1.00)?
- Up to 100 (35 cases)
- 100–200 (9 cases)
- 200–500 (24 cases)
- 500–1,000 (34 cases)
- 1,000–10,000 (84 cases)
- 10,000–100,000 (30 cases)
- More than 100,000 (4 cases)

What were your profits in 1990 (millions of zloty)?
- Up to 50 (74 cases)
- 50–100 (27 cases)
- 100–200 (25 cases)
- 200–300 (2 cases)
- 300–400 (3 cases)
- 400–1,000 (4 cases)
- 1,000 and higher (29 cases)

What were your profits in 1991 (millions of zloty)?
- Up to 50 (63 cases)
- 50–100 (34 cases)
- 100–200 (19 cases)
- 200–300 (15 cases)
- 300–400 (6 cases)
- 400–500 (6 cases)
- 500–1,000 (9 cases)
- 1,000 and higher (27 cases)

How many customers do you have?
- 1 (7 cases)
- 2–5 (28 cases)
- 6–10 (21 cases)
- More than 10 (227 cases)

The market for your product(s) is:
- Local (65 cases)
- National (105 cases)
- National and foreign (54 cases)
- Only foreign (3 cases)

million ($5,000), while over thirty firms earned more than Zl 400 million ($40,000). Note that, while most sampled firms answered most questions, about half of all firms declined to answer questions about profits.

Without doubt, by Western standards most of these randomly selected "active" Polish private firms are small. However, table 16.15 shows that it is not correct to characterize them as tied to one state firm or as serving only a local market. The vast majority of all firms reported having more than ten customers, and in 105 cases entrepreneurs said that their market was "national." Surprisingly, fifty-seven of these private firms (19 percent of our sample) reported exporting some goods.

We were interested in the entrepreneur's family background because it has been suggested that this is an important factor in determining who becomes an entrepreneur. Table 16.16 shows some interesting evidence in this regard: in about one-third of all cases, the entrepreneur's family had run another business in the past ten years. Interestingly, however, only forty-eight respondents said that their firm was established "as a family tradition." We took this to mean that a family background in private business is conducive to entry into the private sector but not necessarily into exactly the same activity.

The vast majority of entrepreneurs replied that this firm was the result of either their initiative or that of a partner. Only five firms were spin-offs of some kind from another firm. However, about one-third of the entrepreneurs had worked in the private sector before establishing their own firm, and about the same number had held a management position in a state firm. This indicates that one-third of sampled entrepreneurs either held no previous employment or were workers in state firms.

According to the responses shown in table 16.17, most of the entrepreneurs started with money saved from earnings in Poland. In forty-two cases (14 per-

Table 16.16 The Entrepreneur's Background

Has your family run another business in the past ten years?
- Yes (101 cases)
- No (190 cases)

Was the company established:
- On the interviewee's and/or a partner's initiative?
  - Yes (227 cases)
- On the initiative of another company?
  - Yes (5 cases)
- As a family tradition?
  - Yes (48 cases)

Did you work in private sector before establishing your own company?
- Yes (112 cases)
- No (155 cases)

Did you ever have a management position in a state firm or a cooperative?
- Yes (111 cases)
- No (166 cases)

Table 16.17 Financial Information

What was the source of your initial capital (respondents could give more than one answer)?
- Domestic earnings (214 cases)
- Earnings abroad (42 cases)
- Loans from family and friends (80 cases)
- Bank credit (34 cases)

Have you applied for credit in the past two years?
- Yes, successfully (71 cases)
- Yes, unsuccessfully (32 cases)
- No (183 cases)

If you obtained credit, was it:
- In zlotys?
  - Yes (62 cases)
- In hard currency?
  - Yes (13 cases)

Do you have any debtors (trade credit)?
- Yes (130 cases)
- No (162 cases)

Do you have any creditors (trade credit)?
- Yes (92 cases)
- No (200 cases)

How do you finance turnover (respondents could give more than one answer)?
- With own funds (256 cases)
- With bank credit (42 cases)
- With supplier credit (76 cases)

How do you use your profits at present (respondent can choose more than one answer)?
- To increase turnover (129 cases)
- To purchase fixed assets (143 cases)
- To pay dividends to shareholders (9 cases)
- To build reserves (46 cases)
- To make outside investments (stocks, bonds etc.) (21 cases)
- Other (72 cases)

If your profits increase, you will (respondent can choose more than one answer):
- Increase turnover (162 cases)
- Purchase fixed assets (126 cases)
- Stop using bank credits (34 cases)
- Increase inventory (48 cases)
- Make long-term deposits (17 cases)
- Increase financial reserves (48 cases)
- Buy securities (14 cases)
- Pay dividends (9 cases)

cent of the sample), they had savings from foreign earnings. About the same number of entrepreneurs started out with bank loans, and eighty people reported using some money from family and friends.

Interestingly, table 16.17 also shows that relatively few entrepreneurs have ever applied for credit—only one-third of our sample. These numbers indicate that two-thirds of Polish private businesspeople do not even try to borrow money. Many firms also operate without giving or receiving trade credit—162 interviewees said that their firms had no debtors, and 200 said that they had no creditors. Of those who had obtained credit, thirteen said that it was in hard currency.

Table 16.17 shows that most private firms reinvest their profits. Around half said that they used profits to increase turnover, and 162 said that they would do that if profits increased. Fixed assets are purchased out of profits by 143, and 126 would do the same with higher profits. Only twenty-one presently make investments outside the firm. Clearly, the growth of these private businesses is based on their own retained earnings.

Table 16.18 shows that most of these entrepreneurs consider their competition to be either other private companies or black marketeers. When asked to name the main three barriers to rising sales, limited demand was named by 163. More interesting, however, is the fact that—adding across the first-, second-, and third-named barriers—a lack of employees adversely affects thirty-eight firms (13 percent of the sample). We believe that this indicates both the lack of skilled labor in Poland and the fact that the Warsaw labor market is actually quite tight.

Very few of these firms use consulting firms or lawyers, but just under half use an accountant, at least part-time. The hiring of accountants is easy to explain—Polish tax regulations are complex, and one bookkeeping error could bring on a much-feared investigation by the tax authorities.

16.3.3 Analysis

The information from our sample of Polish firms confirms the broad picture of private-sector development that we outlined above. In addition, we have uncovered some data that confirm or clarify prevalent opinions about the Polish private sector.

Where did these private entrepreneurs come from? About one-third had families with business backgrounds. Most of them started their firms themselves, with their own money. Where did they get the experience and the capital necessary to do this? For about half, the answer is previous work in the private sector, and slightly more than a third had previous work experience as managers in the state sector. The liberalization of this sector under the Communists appears to have had useful, lasting effects.

The private sector provides its own capital. Most of these entrepreneurs do not borrow money, and their growth is based on reinvested profits. This is consistent with anecdotal evidence suggesting that the rapid growth of the Polish private sector since the beginning of 1990 was due to the existence of high rates of profit in some activities—particularly wholesale trade.

For all their successes, most Polish private firms remain small and compete mostly with other private firms. As expected, it is now apparent that some will continue to grow while others will remain small. But it is far from clear how fast firms can grow when that growth is based only on retained profits. Yet there is little credit available to the private sector, and the much-vaunted priva-

Table 16.18 **Strategy**

Who are your main competitors?
- Black marketeers (73 cases)
- Other private companies (153 cases)
- State owned companies (32 cases)
- Cooperatives (12 cases)
- Foreign firms (27 cases)
- Imports (34 cases)
- None (36 cases)

What are the three main barriers to increasing your sales (rank them in order)?

First:
- Lack of orders (163 cases)
- Lack of employees (14 cases)
- Taxes (27 cases)
- Legal/administrative (14 cases)
- Other (53 cases)

Second:
- Lack of orders (29 cases)
- Lack of employees (20 cases)
- Taxes (53 cases)
- Legal/administrative (35 cases)
- Other (27 cases)

Third:
- Lack of orders (11 cases)
- Lack of employees (4 cases)
- Taxes (12 cases)
- Legal/administrative (12 cases)
- Other (24 cases)

How often do you use the services of lawyers?
- Never (130 cases)
- Sometimes (3–10 times) per year (72 cases)
- Once a month (12 cases)
- Several times a month (26 cases)
- Every day (50 cases)

Do you employ a bookkeeper?
- Yes (136 cases)
- No (153 cases)

tization program has so far had little effect on already-existing private businesses.

16.4 Conclusions

Our evidence has shown considerable differences among the conditions of the private sectors in the CSFR, Hungary, and Poland. The private sector has done well in Hungary, in part because there was a steady liberalization of the private sector over a long period. The Polish private sector has also done well, primarily because it was able to grow in the midst of an unstable macroeconomy. Private firms in the CSFR remain small and have a long way to go.

The recent history of economic reforms—in the last ten to twenty years—continues to shape the fortunes of the private sectors in these countries. At first this seems strange because their Communist regimes for the most part succeeded in imposing a very similar economic structure on all three countries.[106] Although further research is needed, our working conclusion is that the Communist economic reforms of the 1980s established—probably inadvertently—the basis for sustained Polish private-sector development. Reforms conducted at the same time in Hungary had similar—but probably more intentional—effects, but the form taken by the private sector in Poland and Hungary was rather different. What were the important differences between the Hungarian and the Polish economic reforms?

In Poland, there was much more liberalization of travel and informal importing. There was also, from the beginning of 1988, a much worse macroeconomic situation in which the government lost control over the inflation rate. Permissive legislation was introduced at the same time as there were enormous discrepancies between prices inside and outside Poland. It was individuals who made money and gained experience in this situation. Corporate forms were sometimes convenient, but they were never essential to private-sector development. Because the Hungarian economy remained more tightly controlled, similar "hothouse" conditions were never created, and private-sector development was more even paced.

This helps explain why the unincorporated private sector is stronger in Poland whereas the private corporate sector is more developed in Hungary. Individual enterprise is stimulated more by the availability of foreign travel and small-scale import opportunities. The relatively stable macroeconomic environment of Hungary means that more capital is needed to start a private firm, and this requires the use of a corporate form. Moreover, as our survey research shows, Polish entrepreneurs live and grow on internally generated capital, partly because the capital market is not well developed. The capital market is better developed in Hungary, and this permits larger-scale private enterprise. (However, in order to make a deeper analysis of the Hungarian private sector, we would need to conduct a survey similar to that in Poland.)

What is the secret of the relative success of the private sector in Poland? In part, it was the historical sequence of events. The Communists' partially reformed economy was a good place to learn how to do business. The economic reform program rapidly changed the economy, to the relative benefit of small, flexible firms that could adjust quickly. The achievements to date have been so remarkable that it is almost possible to speak of a Polish private-sector miracle. But one element is still missing: there is no bank credit at low nominal and real interest rates.

There are few obvious conclusions for the CSFR and other countries that

106. It is true that agriculture was never successfully collectivized in Poland, but we have not seen evidence that private agriculture was the basis for rapid growth in the urban Polish private sector. In fact, private farmers have been among the most vociferous opponents of the economic program that began in 1990.

abandoned communism before their private sector was significantly developed. Some of these countries now have similar policies as Poland but have not yet had such rapid growth. It makes no sense to suggest that they try to create a Polish-style "hothouse" because these conditions also involve terrible macroeconomic imbalances—and these helped bring down the Polish Communist regime. The CSFR has little choice but to maintain its existing policy combination: attempt to hold down inflation, maintain an open economy, provide modest tax incentives, and keep credit reasonably priced. Some measures to provide special assistance to small business have worked in industrial countries and have already been proposed for the CSFR (see Rondinelli 1991). In essence, this implies trying to follow the Hungarian path of gradual and more steady private-sector growth, although without the Hungarian acceleration after 1989.

There has been discussion of various innovative ways to stimulate the private sector in post-Communist countries. A significant amount of unmortgaged private property exists in these countries. There may be legal changes that would allow an individual to sign away his or her protection from eviction—this would facilitate the development of mortgage credit. Policymakers are also aware that accelerating small privatization would definitely help put physical capital in the hands of private business. Furthermore, following successes in selling shops and restaurants, in Poland and Hungary measures have been taken to promote a separate track for the privatization of "small" industrial assets. However, given their current situation, it will be hard for the CSFR and other Communist countries to emulate the success of either Hungary's or Poland's private sector.

These conclusions suggest partial answers to the three questions raised in the second paragraph of the introduction. There are measures that post-Communist governments can and have used to accelerate private-sector growth, but the effectiveness of these measures depends on how much the private sector grew under the Communist regime. There are at least two paths to private-sector growth, one typified by Hungary and the other by Poland. In both cases, the results so far have been impressive, but it remains unclear whether they provide the basis for a modern, industrial economy.

Appendix
Sample Selection for Polish Entrepreneurs

Our full sample consists of 294 companies that were interviewed in Warsaw in the last three weeks of November and the first week of December 1991.[107]

107. Most of the detailed work described here was performed by Piotr Strzalkowski and his associates at MCR Research.

These companies were selected from a data base of about 3,000 firms that advertised themselves in the Polish press in the last two months of 1990. For obvious reasons, we were able to interview only those firms that were still in business at the end of 1991. Interviews were conducted by a team of twenty people, trained and supervised by MCR research.

The list of firms that advertise was obtained from *Gazeta Wyborcza*, which is available throughout Poland and has seventeen local editions. Three other newspapers were used: *Rzeczpospolita, Zycie Warszawa* (60 percent of the copies are sold in Warsaw), and *Kontakt. Kontakt* is not a popular daily but rather a specialized paper in which manufacturing firms advertise. It was included because manufacturing firms less often advertise in daily newspapers—most of this advertising is done by firms offering nonmaterial services, particularly trade.

In order to qualify for inclusion in the data base, a firm had to give in its advertisement its name, address, and telephone number. In many Polish advertisements, a firm gives only its phone number or its name and phone number. We judged these "firms" more likely to be one-off trade shipments, and we did not wish to include them in our sample.

Our category *traditional services* comprised primarily services in which private-sector activity had been allowed before 1990. These include automobile repair, miscellaneous repairs, shoemaking, tailoring, and carpentry. These need to be contrasted with *modern services*, such as consulting, advertising, accounting, and finance, which the private sector has started doing only recently. Our other categories of firms were production, transport, restaurants, retail trade, and wholesale trade.

With the data base prepared, we then consulted official statistics (published by the State Statistical Office, GUS) to determine the proportions of different sectors that should be selected for our sample. As far as possible, we attempted to achieve the same relative proportions of sectors in our sample as exist—according to GUS statistics—in the population of Warsaw private firms.

There is one feature of our sample that may seem at first strange. Our sample contains only twenty retail firms but eighty wholesale firms. The reason for this is simple—for some months in 1990, there was available a complete one-year tax holiday for anyone registering to do wholesale trade as a physical person and operating for the first time at a particular address. There is ample anecdotal evidence that many people, particularly retailers, were able to take advantage of this tax break.

Interviews were conducted by native Polish speakers, coordinated by MCR Research. Some firms in the sample were phoned at random to check that the interviewer had actually been there. These interviewers were experienced subcontractors of MCR Research and were instructed to ask follow-up questions when an answer was unclear and to build rapport with the interviewee—particularly with a view to extracting financial information.

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Discussion Summary

Kalman Mizsei suggested that Johnson had exaggerated the contrast between the development paths of the Polish and the Hungarian private sectors. First, Mizsei said that, like Poland, Hungary recorded a dramatic boom in private-sector growth at the end of the 1980s. He noted that, by 1988, only 450 limited-liability firms had been established in Hungary; by 1991, 41,000 such firms were incorporated. Second, Mizsei emphasized that, like Hungary, Poland had a long history of liberalization under Communist rule. He cited the economic liberalization following the 1981 Polish political crisis, and he mentioned the prevalence of Polish "trade tourism" and employment abroad during the 1970s. Third, Mizsei argued that Johnson had overstated the relative importance of unincorporated private enterprises in Poland. However, Mizsei did highlight one area in which the Polish and Hungarian experiences have substantially differed. He noted that, under Communist rule, the second economy in Hungary had been oriented toward production, in contrast to the speculative focus of black market activity during Communist rule in Poland (e.g., illegal trade in foreign currency).

Mizsei discussed several financial issues that pertain to Hungary. He noted that lax bankruptcy laws have enabled private entrepreneurs to strip the assets of bankrupt firms. He suggested that Hungary's policy of giving preferential credits to individuals who purchase state assets generates pricing distortions and raises the likelihood of corruption. Finally, he said that the banking sector is taking an increasing interest in attracting deposits from and making loans to the private sector. He said that credits to the private sector represent 30 percent of the total credit in the portfolios of Hungary's three largest banks. He argued that the general issue of financial intermediation had received too little attention at the conference.

Mizsei also described the status of the Hungarian privatization agency, the

SPA. He said that, in 1991, the SPA reported $40 billion of foreign-currency sales, with $35 billion coming from foreign investors. He noted that, in response to political pressure to get a fair price for state assets, the SPA has insisted on sale prices that are often too high to attract any buyers. Finally, he said that the SPA has not finalized any of the privatization deals that the agency has initiated itself. He said that most of the deals that have been completed were initiated by state enterprise managers.

Mark Schaffer said that Johnson had not acknowledged the important role that the privatization of small-scale enterprises had played in the growth of Polish private-sector employment. He noted that, in 1990, the private sector recorded a net increase of over 500,000 jobs. Approximately 400,000 of these jobs appeared in private firms in the trade sector. At the same time, jobs in the socialized trade sector fell by 400,000, a one-third decrease for that sector. Schaffer concluded that these large employment shifts occurred because of the government's emphasis on privatizing small shops in the retail trade sector.

Lev Freinkman and *Jan Winiecki* supported Mizsei's argument that Johnson had exaggerated the contrasts between the paths of private-sector development in Poland and in Hungary. Winiecki noted that, in 1989, the last year of Communist rule, both Poland and Hungary recorded that employees of private firms accounted for 10 percent of total employment in the industrial sector. Winiecki also provided some details about the program of small-scale privatization in Poland. He noted that the term *privatization* is misleading since 98 percent of the firms were not sold but rather leased. He said that this has generated perverse incentives with regard to the maintenance of the leased assets.

Simon Johnson conceded that he may have overstated the contrasts between private-sector development in Poland and Hungary, but he argued that there were important differences. He agreed with Winiecki that the private sectors in the two countries looked remarkably similar in 1989. Johnson noted, however, that the two countries were very different in 1985, when Hungary had a strong second economy and the private sector in Poland was small and was not developing. Johnson suggested that Hungary's 1989 boom in limited-liability companies probably was driven by state-owned capital, not private entrepreneurs; the minimum capital required to start such a firm was roughly equivalent to $20,000. At the same time, it took only $5.00 to form a joint-stock company in Poland. Finally, Johnson argued that much of the Hungarian private-sector growth in the late 1980s reflected legalization of already-existing activities, while in Poland this source of growth was less important. During this period, Poland experienced more of an actual change in the level of private-sector participation.

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