

**Institutional Change and Firm Creation in East-Central Europe:  
An Embedded Politics Approach<sup>^</sup>**

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### **Abstract**

A central debate about the transformation of post-communist countries is how the process of institution building impacts firm restructuring and creation. This debate has largely been dominated by a *tabula rasa* view that emphasizes depoliticized models of epochal change and a *continuity* view that emphasizes the determining impact of pre-existing social structures. These views, however, have serious problems explaining one of the key comparative developments in East-Central Europe – the strong growth in Poland and the virtual economic collapse of the Czech Republic, once the star of both the *tabula rasa* and *continuity* views. This paper explains these performance differences by offering an alternative, *embedded politics* approach that views firm and institutional creation as intertwined experiments to reorganize existing public-private relationships. In this view, Czech attempts to implant a depoliticized model of reform impeded the necessary reorganization of the socio-political networks, in which firms are embedded. In contrast, Poland facilitated institutional experiments not only in the ways it promoted negotiated solutions to restructuring, but also in the ways it empowered sub-national governments. The study utilizes data on manufacturing networks, privatization, bankruptcy, and regional government reforms collected over the past six years.

## Introduction

A central debate about the transformation of post-communist countries is how the process of institutional creation impacts firm restructuring and creation. To date, two literatures on industrial development and entrepreneurship have informed this debate. On the one hand, the economic and often developmental statist views are reflected in reform approaches that understand transformation as discontinuous change from communism to capitalism, whereby a coherent, autonomous state imposes a new “right” set of rules and incentives on firms and banks.<sup>1</sup> On the other hand, sociological views are reflected in reform approaches that emphasize the continuity of past social structures determining firm strategy and policy choices.<sup>2</sup>

The problem is that neither of these approaches offers a convincing explanation for one of the most significant developments during the past decade in East-Central Europe: Poland’s strong economic growth and the Czech Republic’s stagnation. Indeed, advocates of both approaches viewed the Czech case as a relative success and as a major source of supporting evidence.

This essay explains the Czech failures and Polish success by offering an alternative *embedded politics* approach that views firm and institutional creation as intertwined experiments to reorganize existing public-private relationships to confront new uncertainties. My alternative departs from both approaches because it emphasizes that productive assets are embedded in social and political ties that link the necessary reorganization of inter-firm networks with institutional change at the state level. In this view, distinct groups of firm and public actors created networks with distinct authority structures during communism to obtain resources and to protect themselves from the uncertainties of shortage economies.

Consequently, in the post-communist period, new firms largely emerge not from a *tabula rasa* (as in both the economic and statist paradigms) but as part of the

reorganization of these networked assets. This particular blind spot of the economistic-statist paradigms matters because interlinked assets curb the individual discretion as well as impede cooperation via clear contractual solutions, be they between the state and a firm or bank or between individuals. On the other hand, historical social bonds between firms also can fail to mediate conflicts over asset reorganization since these bonds were derived from relations with public institutions that have either disappeared or, more likely, no longer provide the political or material resources to network authority structures.

The first approach, in short, tends to wish away the bonds of the past while the second, against all evidence to the contrary, seems to believe such 'legacies' continue more or less intact. The approach of this paper is to set experiments in reorganizing private assets alongside the simultaneous experiments of creating new roles for public institutions at different levels of society. One guiding idea is that attempts by the state to impose its own well-crafted organizational and institutional designs are unconvincing. While attempts to maintain a powerful, insulated state would tend to impede the experimental nature of economic and institutional transformation, attempts to empower a variety of national and sub-national governmental bodies would tend to facilitate it. Put bluntly, the Poles appear to have learned this lesson more thoroughly than the Czechs have.

Section I critiques the two dominant approaches and briefly reviews the main points of an embedded politics approach in light of the stark differences between Poland the Czech Republic in terms of both their policies and the growth in industrial output and new manufacturing firms. Sections II and III then explore these arguments empirically, using network and institutional data from the two countries.<sup>3</sup> The upshot is that institutional experiments based on public actors becoming financial partners and conflict mediators enhance the ability of network actors to learn and monitor one another, and thus experiment with new forms of organization. Poland facilitated such institutional experiments not only in

the ways it helped structure negotiated solutions to ownership change and asset restructuring, but also in the ways it decentralized power and resources to sub-national political actors to partake in these solutions.

## **I. Explaining the Divergence in Growth and Firm Creation**

By the mid-1990s the Czech Republic was viewed as the crowning success of the depoliticization model advanced by those who viewed transformation as one of epochal change – a leap from one complete set of organizing principles to another.<sup>4</sup> In this view, communist countries were essentially composed of a unified party-state hierarchy commanding atomized firms or individuals. During transformation, an insulated state alone can and should define and impose a new institutional order upon a *tabula rasa* of atomized, self-interested actors, who have a history of cancerous bargaining relations with former state officials. Depoliticization is the ability of the state to eschew negotiations with economic and social actors about the initial institutional designs and their subsequent revisions by cutting off a powerful “change team” from society to impose rapidly a new set of rules that directly guide actors toward efficient resolution of restructuring conflicts.

The depoliticization agenda rests on two key premises regarding firm creation. First, a powerful, internally coherent central state policy apparatus must be insulated from particularistic interests in order to implant rapidly a new set of rules, be they through mass privatization, liberalization, or well-defined short-term assistance programs, such as to existing banks. Second, immediate implementation of the new rules supposedly provides the incentives for complete, technical solutions to restructuring conflicts and investment, and thus avoids the need for social and economic actors to engage the government in a renegotiation of the new rules. For economists drawing on Kirzner, von Mises and Hayek’s ideas of the entrepreneur as arbitrageur, rapid, mass privatization and market liberalization allows various claimants to assets strike “efficient bargains” so that resources can be quickly

directed to the enterprising investors. These bargains are typically complete contract solutions like the consolidation of control rights over assets and cash flows, the liquidation of loss makers and delinquent debtors, and the creation of enforceable contracts for outsourcing and alliances. For statist, financial assistance and the disciplining of banks come from clearly enforceable rules that are defined *a priori* by the state.

From the depoliticization view, the Czechs were a textbook case.<sup>5</sup> Orthodox communist policies left the Czech Republic with a stable macro-economy, low foreign debt, poorly organized social and political groups, and a central government with virtually complete legal control of assets. A coalition led by Vaclav Klaus used these conditions to construct a strong policy apparatus that cut itself off from potential “rent-seekers,” such as parliament and special interest groups. It immediately dissolved regional councils, blocked their re-establishment until 1998, and reduced the powers and resources of district and fragmented municipal governments. It then sought to end-run the potential hold up power of firm and bank managers by rapidly liberalizing trade and most prices, enacting conservative monetary and fiscal policies as well as strict banking regulations, creating bankruptcy laws based on liquidation of defaulting debtors, instituting a limited, rule-based recapitalization of banks, and, privatized over 1,800 firms and four of the five main banks in less than four years through its now famous voucher method.

In contrast, Poland was deficient in all these areas.<sup>6</sup> Policies of partial economic and political liberalization, particularly in the 1980s, left the country with relatively large fiscal deficits and foreign debt and relatively well-organized social groups and competing political factions, notably in Solidarity and the farmer associations. These economic factors created multiple goals for privatization, such as maximizing sales revenues and maintaining employment, rather than simply keeping privatization focused on the rapid delineation of private ownership rights and creating a new coherent economic governance order. The

political factors allowed for different political groups to contend for policy control and enabled stakeholders, such as workers councils, managers and local governments, to intervene in, if not exercise veto rights over, the privatization of assets. The merry-go-round of Polish governments were then forced to include several potentially conflicting aims into privatization and banking policies as well as engage in the arduous task of re-claiming full control over assets in order to privatize them. In turn, although Poland successfully implemented a stabilization plan to eliminate hyperinflation, it experienced stop-and-go policies in privatization and the reforms of banking and commercial laws. For instance, between 1990 and 1995, Poland was unable to initiate rapid, mass privatization but had central and regional governments administer complex programs for the leasing of firms by employees and the restructuring of bank debt.

Czech adherence to depoliticization received praise from both independent scholars and the multilaterals, boosting confidence in using the model elsewhere, including Russia.<sup>7</sup> As can be seen in Table 1, by 1995 the Czechs raced ahead of Poland in the transfer of property from state to private hands, especially in industry and banking. The Czech Republic became the only post-communist country to obtain investment grade status. And while Czech banks exceeded the Basle banking capital adequacy ratios by 1994, studies showed that Czech start-ups and small and medium sized enterprises (SMEs) had relatively greater access to bank credit than their Polish counterparts.<sup>8</sup>

#### **Ia. A Closer Look at the Data**

The eventual outcomes of these contrasting approaches to transformation, however, undermine the depoliticization model. As shown in Figure 1 and Tables 2 and 3, the Czech Republic has significantly lagged Poland in the growth of GDP, industrial output, industrial labor productivity, and the creation of new manufacturing firms (SMEs), which has fueled much of Poland's economic revival.<sup>9</sup> Moreover, while both countries have maintained fiscal

discipline, the Czech Republic's external debt position has gradually worsened and Poland's has greatly improved.

Ironically, the two proposed motors for Czech economic growth – the capital market and bank finance – collapsed. On the one hand, both independent scholars and even the World Bank have shown that Czech mass privatization did not facilitate firm restructuring and new firm formation.<sup>10</sup> At best, the subsequent creation of large investment funds with cross-holdings in the main Czech banks led to mismanagement of assets. At worst, new Czech entrepreneurs reaped profits through insider trading schemes and asset stripping. On the other hand, the Czech government has had to bailout the main Czech banks repeatedly during 1995-2000. From 1991 to 1998, the Czech government spent over 25% of GDP to restructure banks, whereas the Polish government spent only 7%. By the end of the 1990s, over 30% of loans in Czech banks were classified as non-performing, whereas in Poland the figure was about 10%.<sup>11</sup>

In sum, the Czech model of rapid privatization, a one-time recapitalization of banks, and bankruptcy as punishment and liquidation led banks and new owners to view the restructuring of existing firms as too risky. New firm creation suffered from the lack of spin-offs and access to new forms of sub-contracting and resources. For instance, by 1998, no firm, old or new, used the Czech bourse to raise capital while Poland saw a substantial rise in the liquidity and amount of capital raised in its bourse.<sup>12</sup> And in 1999, as creditors made little progress in voluntary workouts, a new government owned restructuring and re-privatization took control of seven of the largest manufacturing firms.

Two prominent works attempt to save the depoliticization/tabula rasa approach. Johnson and Shleifer (1999) argued that Polish capital markets work better than Czech ones, since the Polish version of voucher privatization used securities laws provide for relatively better protection of minority shareholder rights. But its impact on growth and firm creation is



questionable, as the program was not implemented until 1995-96, and its limited scope of 512 firms (10% of industry and construction sales) have to date performed below the national sectoral averages.<sup>13</sup> Johnson and Loveman (1995) also argued that Poland's growth comes from de novo private SMEs, which emerge from strict fiscal and monetary policies, liberalized markets, and protected private property rights. Yet it would be difficult to argue that Czech government adhered to these principles than the Polish government did.

Together, these empirical problems emerge from a more general theoretical dilemma of trying to draw a bright line between public and private sector activities. For instance, both works seem to ignore the obvious impact that the variety of government interventions – such as its continued 25% ownership of the 512 firms in voucher privatization, creation of privatization funds, lease of firms to employees, regional development agencies, and restructuring of bank debt in large firms – could have on the way institutions or firms emerged in Poland. Similarly, Johnson and Loveman's own empirical evidence shows the importance of linkages between existing state firms and new private manufacturing firms as channels of sales, supplies, facilities, and personnel.<sup>14</sup>

### **Ib. Continuity and the Role of Socio-economic Networks**

The foregoing suggests that one cannot explain dynamic new firm formation without understanding the linkages between the past and the present or the inherited state sector and the emerging private one as both constraints and resources for restructuring. Much of the work in economic-sociology can be helpful here, notably for its stress on existing inter-firm networks, as opposed to market signals or individual firm capabilities, in determining the ability of firms to adapt. In this view, the different structure, density, and strength of inter-firm ties help gauge the ability of firms to cooperate, access new information, maintain market positions, and innovate.<sup>15</sup>

The work of David Stark is the most prominent in extending the field into analysis of post-communist countries.<sup>16</sup> Stark was among the first scholars who showed that communist economies were less collections of atomized firms hierarchically commanded by the party state and more akin to constellations of firms embedded in a variety of horizontal and vertical social and economic ties that grew out of improvised responses to the uncertainties of the shortage environment. He further argued that after the collapse of communism, firms remained embedded in these ties, turning problems of restructuring into inter-firm network issues that link the existing state sector to the emerging private sector. The reproduction of network ties provided constituent firms with reliable channels of resources and information as well as norms of reciprocity to help “recombine” assets in a variety of ways.

Stark’s use of mid-range analytical categories, like networks, helps one compare the distinctive patterns of economic organization across countries as well as over time, such as before and during transformation. However, in his emphasis on the preservation of network relations, Stark over determines the ability of old ties to govern asset reorganization under new uncertainties in ways that lead to productive outcomes, rather than, say, to self-dealing or mismanagement. For instance, Stark argues that the Czech case is a prime example where past informal network relationships were well preserved and formalized into sound governance institutions *writ large* by a responsive government. His evidence is the emergence of the complex interlocking ownership and financial links among the main Czech banks, their investment funds, and the overlapping portfolios of privatized state firms. In light of the evidence on Czech privatization discussed above – both the aggregate economic data as well as the virtual collapse of the Czech capital market – one must question whether the reproduction of “old school” ties are sufficient mechanisms for governing restructuring. Any vestiges of associationalism were apparently insufficient to help the banks, funds, and

firms cooperate on restructuring and invest into firms, even after the government offered financial assistance to relieve bank and inter-firm debt.<sup>17</sup>

One could argue that Poland's second economy from the 1980s accounts for its growth in new manufacturing firms. Yet not only was Poland's proto-private sector largely restricted to agriculture, but also one would still have to explain why Polish networks were any more predisposed to productive cooperation than Stark's Czech networks.

Such empirical problems reveal a theoretical limitation to the work in economic sociology. In focusing on socio-economic ties among firms, this approach is remarkably silent about how political and institutional changes may inter-act directly with network reproduction, other than emphasizing policies that preserve past network ties. Yet if past norms were insufficient to help firms cooperate over restructuring and debt reduction, as in the Czech case, then either the inherited network relationships had been altered in some significant way or they lacked qualities in and of themselves to help firms adjust to the new uncertainties. Either way, one would have to consider how political-institutional factors shape both the origins and adaptability of inter-firm networks.

### **Ic. An Embedded Politics Approach**

The alternative, *embedded politics* approach advanced in this paper attempts to identify factors that continue to shape and constrain firm strategy, such as economic and social links that tie actors to common assets, as well as factors that can alter the structure and cohesion of inherited networks, such as specific institutional supports for networks. This approach departs, then, from conventional network analysis in understanding that firms are embedded in *socio-political* networks that are constructed and re-constructed by specific firms and public actors under different political-economic regimes.<sup>18</sup> In this view, political factors, such as changes in the redistribution of public power and resources, can determine how inter-firm conflicts over common assets are resolved to promote or impede firm formation.

The research on sub-national economies has emphasized the political-institutional architecture that was interwoven with inter-firm relationships.<sup>19</sup> Similarly, there is increasing evidence from a variety of East European countries that industrial networks included not just firms but also regional bank and party council officials.<sup>20</sup> For instance, my own research has shown that even in the relatively orthodox communist Czechoslovakia planning experiments allowed mid-level institutions, such as industrial associations (VHJs) and regional councils, to take on greater decision-making rights over, respectively, production and the provision of social-welfare services.<sup>21</sup> Distinct patterns of industrial networks grew around different VHJs. Constituent suppliers, customers, managers and work groups formed alliances with local state bank branches and party councils to gain privileges from the state center and create informal channels of coordination to adjust to the uncertainties of the shortage economy. These alliances solidified the network authority structure, since they were sources of political and financial risk sharing to limit central intervention and facilitate the autarky and improvisation needed to adapt to an ineffective planning structure.

In the embedded politics approach, a key variable is power. The power a firm or plant may have over assets and the creation of formal and informal rules of inter-firm relations is derived from not only one's position in the value-chain, such as a critical supplier or purchaser, but also the strength of one's ties to local public actors, such as bank and party-council officials during communism. A network may be more hierarchical or more egalitarian, depending on the mix of these two factors. This understanding of the construction of the authority structures of economic networks becomes critical for post-communist restructuring in two ways.

First, alterations in the authority structure of a network emerge from both changes in the economic environment, like the relative importance of a particular product, and changes

in the political-institutional environment, like the re-organization of the central and sub-national governments, privatization rules and financial regulations. Under new uncertainties, interdependent firms may be unable to cooperate over the reorganization of common assets. The ability of one firm to impose its will on or give reliable guarantees of compensation to another depends not only on the risk associated with the investment and the historical bonds between them but also the support of public actors who may be no longer available. For instance, in the Czech Republic (CR) firms often lost their authority and access to resources when the centralization of policy-making power virtually eliminated regional and local councils and the rapid privatization of banks and the new financial regulations gave the banks little incentive to finance restructuring.

Second, in linking institutional and asset-reorganizational experiments, the approach can help clarify the conditions that promote cooperation and lead to dynamic firm creation. As suggested already by my discourse, the recombination of network assets is an iterative negotiating process at two levels: the selection of restructuring projects and the creation of rules (formal or informal) about monitoring one another. Akin to corporate workouts via Chapter 11, this process is fraught with questions of how risk is shared and how the process is governed. The history of western capitalism has shown that workouts for firms and banks demand that public actors share some of this risk and adjudicate conflicts over the control of assets and liabilities. Similar to discussions about the differences between “law on the books” and “law in practice,” this history has also shown that the creation of institutions to facilitate workouts, be they directed by a central bank, a national or provincial ministry, or the courts, is as much about the experimenting with different rules as it is about the distribution of power and resources.<sup>22</sup> In turn, the restructuring of existing networks that lead to growth and firm formation in East-Central Europe will depend largely on both the ability

of public actors to become risk sharers and conflict mediators and the ability of the political system to allow public actors to experiment and learn to take on these new roles.<sup>23</sup>

The rest of this paper will empirically illustrate this argument, first by analyzing the Czech machine-tool firms. Although these firms were a historical engine of growth, embraced privatization, and had many ideal network traits, they became insolvent and then closely linked to the near-collapse of a key part of the Czech financial system. Using an embedded politics approach to explain the fragmentation of this network helps identify key differences in the Czech and Polish approaches to institutional change that can help explain their contrasting abilities to facilitate network restructuring and firm creation. Whereas the Czech approach attempted to maintain a powerful central state that drew bright lines between the public and the private, the Polish approach understood restructuring as a negotiated process, in which different groups of firms, banks, ministries, and regional administrations experimented with a variety of means to monitor one another's use of common assets.

## **II. The Fragmentation of Old Ties**

Czech machine tool firms form a vital part of the country's machinery and equipment sector, which was the engine of industry for the Czech lands from the beginning of the 20<sup>th</sup> Century well into the 1990s.<sup>24</sup> The Czech firms were the premier machine tool suppliers in the communist trading bloc and among the top 8 nations in machine tool production in the world for much of the post-WWII period. Since the mid-1970s, scholars have viewed the machine tool industry worldwide as a paradigmatic example of SME creation and flexible specialization.<sup>25</sup> With their decades of experience, network ties, and embrace of rapid privatization, Czech machine tool firms were poised to join this trend after 1990.

By 1990 the machine tool industry was already organized into many legally independent firms, as opposed to a few large, vertically integrated firms that were common in other branches.<sup>26</sup> During communism, the industrial association or VHJ, TST, managed the

large majority of firms and plants that produced machine tools and many of their key components. By the late 1980s, TST had over 20 member firms, comprising about 30,000 employees and a rather broad production profile of machines and components. When Czechoslovakia dissolved the VHJ system in 1987-88, TST members (including many plants) chose to become legally independent state firms. This movement toward deconcentration grew out of TST's *polycentric* network, which possessed many qualities associated with entrepreneurial networks that facilitate the transfer of tacit knowledge, flexibility, and access to new information and resources.<sup>27</sup> (See Figure 2.) Structurally, member firms had retained considerable decision-making powers and independent financial accounts, and worked with the TST directorate on a rather consensual basis. Relationally, members had a deep history of overlapping, direct social and professional ties. But power asymmetries were limited, since firms were usually horizontally associated and had often generated their own links outside of TST. For instance, a TST firm typically focused on a certain class of machines, had several plants, and produced over 80% of its inputs in-house. While parts like hydraulics, pneumatics, and ball bearings, as well as specific metal castings, came from other members, the firms acquired certain electronic components from other VHJs jointly via the TST directorate or directly, depending on the quality of their local professional linkages. TST firms thus had both rich social ties and opportunities for becoming what the sociological literature calls entrepreneurial "brokers" that find knowledge and resource synergies between different business networks.<sup>28</sup> A key reason for the development of this polycentric network was that most member firms developed direct links to regional bank branches and regional/district administrative-communist party councils. These linkages aided firms in managing inter-firm debts, mediated delivery disputes with non-TST firms in the region, and were sources of countervailing bargaining power vis-à-vis one another, the TST directorate, and the central state ministries.

In 1990-91 and in the face of the dissolution of regional councils, the weakening of district councils, strict banking laws, and rapid privatization, the ex-TST firms embraced privatization, decreased employment, spun off new firms, and grafted indirect equity alliances onto their inherited social ties. The firms and plants entered privatization individually (mostly via vouchers). In 1991, ex-TST firms had already broken themselves up into 40 firms, with the 6 largest allowing their plants to operate as semi-autonomous profit centers and prepare themselves for eventual spin-offs. At the same time, ex-TST firms sought to balance individual autonomy with group cohesion by bolstering past professional ties with new equity and financial ones. In particular, members sought to combine social and equity links to help manage areas in which they lacked individual resources and know-how, such as in foreign trade, common trademarks, critical supplies, vocational training, and development loans. They converted the former TST directorate into the support headquarters of new machine tool association, SST, in which each firm was an owner. SST, in turn, used its historical ties to actors in the trade and financial sectors to take a 30 to 40% equity stake in one of the major trade houses, Strojimport, and build an alliance with members of the foreign trade financial group, FINOP, and the Czech Republic's main trade bank, CSOB. With FINOP and CSOB, SST created a new private bank, Banka Bohemia, and an equity investment company, ISB, whose engineering fund bought strategic stakes in SST member firms and important suppliers/customers.<sup>29</sup> The result of this elaborate equity and financial alliance can be seen in Figure 3. Member firms would renew past direct ties with one another owned, and via SST have a collective brokerage link outside the group. While member firms owned SST, SST ran the boards of Strojimport and the engineering fund, provided strategic information to its members, and aided members in negotiations with banks, notably via Banka Bohemia.

By 1995, however, the machine-tool network had fragmented and most firms bordered on insolvency. The attempt by SST members to preserve their past social relationships,



reinforce them with new governance mechanisms of equity and contracts, and also replace past public external partners with new private financial ones did little to promote cooperation and restructuring.

First, the uncertainties of new production experiments demanded a reorganization of existing network ties and undermined the cooperation between member firms. As each firm began to experiment with new products or alterations of existing ones, they turned to one another for the development or sub-contracting of certain components and the cost sharing of exporting and importing (especially for CNC electronics). Since these experiments were highly uncertain and often conflicted with one another, no firm could give the guarantees to the others to forego their own plans and invest in those of the solicitor. For instance, with the collapse of trade in the CMEA and the domestic recession, SST firms sought new market niches based on short pilot production runs. Even when the solicitor demonstrated that the trial runs were for a credible international client, these runs were often too short with poorly defined future revenue streams to instill confidence in other members to prioritize their own component production for the given project. Experimentation had also led member firms often to encroach on one another's product lines in such a way that had firms fearing that collaboration would undermine individual export revenues.<sup>30</sup>

Secondly, the supporting equity alliances failed to provide needed financing to overcome the hold-up problems among members. As one of the "big-five" Czech banks, CSOB was the critical financial link in the alliance. Yet even with the government's partial recapitalization and debt-relief for the banks, the collapse of CMEA trade left CSOB and Strojimport with large stocks of non-performing credits and weak capital bases. CSOB, in turn, refused to initiate the restructuring of Strojimport and provide credit lines to Banka Bohemia and SST firms. Given the tight interdependencies between the banks and industrial firms, the big Czech banks found it too risky to lead bankruptcies or finance restructuring via the available governance mechanisms of

contracts, liquidations, and ownership (debt-equity swaps), and SST firms languished. Indeed, in 1994, four of the five largest de novo banks, including Banka Bohemia, were seized by regulators and closed.

Without credible structures for negotiated management of common assets and liabilities, the next best options for a firm are to forego collaboration, vertically integrate needed assets, and, ultimately, resort to financial manipulation. Between 1992 and 1995, ZPS, the most successful SST member, more than doubled its total sales and exports by redesigning several of its final and semi-finished products and often selling them at or below cost to gain market share. ZPS had cultivated a network of former employees of the regional council, ZPS and big banks that helped the firm access new export markets and gain financing and strategic information via a set of allied, medium-sized investment funds and banks. As SST relationships fragmented, ZPS found it too risky to engage its initial strategy of gradually spinning off certain plants and utilizing other SST firms for sub-contracting.<sup>31</sup> Instead, ZPS sought to acquire other SST firms by mid 1995, but could not gain adequate funds due to its high leverage and the conservative stance of the big five Czech banks.

ZPS and its local allies, in turn, used their elaborate network of new banks and investment funds to channel financing from the their depositors, notably the partially privatized Czech Insurance Company, to ZPS, gain strategic control of ZPS shares as well as manipulate share prices of ZPS and other companies. At the same time, it sought to control the SST board and the engineering investment fund mentioned above. With its new finances and influence over SST's fund, ZPS orchestrated a series of take-overs of four of the largest SST member firms. This scheme came crashing down in late 1996 when two of allied banks went insolvent and regulators seized Czech Insurance as its weakness threatened the stability of the financial system. After more than 16 months of failed attempts by creditors to reach a voluntary standstill and workout

agreement for ZPS, the firm was forced to enter a new state administered restructuring agency in 1999.

One can begin to make sense of the failure of past social relations and new equity ties to mediate the disputes among SST firms and constrain the domination strategy of ZPS if one integrates political and institutional constructs into the definitions of social capital and networks. As depicted in Figure 2, the alliances that TST firms had with regional and district administrative councils and bank branches were key sources of mediation and authority that supported the polycentric network. While the council and branches collaborated with relevant firms to provide resources and coordinate economic activity, they also provided countervailing power vis-à-vis other strong member firms and the directorate of TST. The Czech agenda of depoliticization altered this equilibrium and undermined the productive reorganization of the machine tool network in two fundamental ways.

First, bent on centralizing power, the central government not only cut off regular communication with firms but also literally and figuratively eliminated traditional external partners of the firms – the sub-national administrations. In turn, the Czech government offered firms only a few private actors with existing resources – namely the main banks and investment funds – as new external allies. Second, to sustain its insularity, the Czech government had to treat the delineation of new ownership rights and restructuring as separate, mutually exclusive policies. The former issue was reduced to rapid, mass privatization. The latter was reduced to a rule-based, one-time partial recapitalization and debt-removal in the main banks and the creation of commercial laws that protected private contracts and defined bankruptcy largely as liquidation. Any alternative that would have linked ownership change and restructuring – such as using lease-purchase options, creating investment-acquisition agreements, or facilitating workouts as part of bankruptcy – would have demanded a variety of forms of government oversight. Moreover, to do so would have demanded empowering

different public actors, be they ministries or sub-national governments, with the necessary discretion and resources to share some of the risks and create rules for the multiple parties to assets to negotiate iteratively over the restructuring of both operations and financing. Czech transformation policy, however, strongly curtailed any such delegation of power and public-private deliberations.

On the one hand, the limited number of potential allies shifted the authority structure of SST's network. Whereas previously the polycentric structure and quasi-brokerage positions of various members emanated from ties to district and regional bank branches and councils, after 1990, as shown in Figure 3, the new alliances with banks and trade companies were concentrated via the SST directorate. The effectiveness of these new alliances depended in part on a level of cooperation among SST firms that had existed only when firms had their own bases of resources and political leverage via, notably, the councils. On the other hand, the new external allies alone lacked the political and financial capital to credibly mediate intra-SST disputes and share risk with these firms – and thus help reconstruct the social ties and authority structure of the network. Restructuring firms via contracts and liquidations were highly risky means for banks to guard their investments. Rather, banks and their funds minimized investment in corporate governance and focused on arbitrage activities in the secondary equity markets. In turn, SST relations fragmented and new resources were unavailable for spin-offs or start-ups in the industry.

Faced with a collapse of SST firms, ZPS viewed taking control of the most valuable SST firms as the main way of preserving its previous gains in the machine-tool market. But ZPS and its financial allies found the prospect of capturing the needed funds from Czech financial institutions – via Czech Insurance – more appealing than delays and uncertainties of decreasing its own leverage. With no credible mechanisms to help firms and banks extend their time horizons and develop new methods multi-party risk sharing and monitoring, the

incentives ultimately lead to systemic failure, when the state can no longer ignore the damage.

### **III. Enabling Restructuring and Institutional Experiments in Poland**

As Czech restructuring slumped, Polish industrial output and firm creation accelerated, without unbridled public spending and despite the slowness of case-by-case privatizations and the delay and limited scope of voucher privatization. An explanation of this relative dynamism can be found in two key ways that the Polish approach to restructuring and institutional experiments (though not always intentionally) has contrasted sharply with the Czech approach. First, the Poles created legal vehicles that enabled stakeholders and outsiders as well as public and private actors to negotiate over time the reorganization of assets and the redefinition of property rights. Second, the central government empowered different ministries and sub-national administrations to initiate, co-finance, and monitor these negotiations – for both large and small firms. By governing change through a combination of delegation and deliberation, the Poles experimented with different policies and roles for public actors that together began to resemble workout vehicles found in advanced industrialized countries: breathing space for the parties to assets to attempt a variety of reorganization projects and rules that promoted mutual monitoring through iterative, disciplined deliberations.<sup>32</sup>

Although I do not have detailed primary network data as in the Czech case, one way to overcome this limitation is to compare the main areas of policy that I have argued contributed to the problems of firm restructuring and creation in Czech manufacturing. (Ragin 1987) Moreover, one of the few primary analyses of manufacturing networks in Poland (Dornisch 1997) showed inter-firm relations were un-cooperative in the early 1990s but improved substantially as national and sub-national government actors began to assist groups of firms and banks in restructuring. This section, in turn, will discuss three major

areas where the Polish approach differed significantly with the Czech approach: privatization, debt restructuring, and the role of sub-national governments. Table 4 gives a summary of these differences.

### **IIIa. Stakeholder Privatization and the Creation of New Firms**

As mentioned in Section I, the 1990 law on Privatization of State Enterprises reinforced the veto powers of worker councils and effectively blocked rapid, mass privatization. But this law also opened two routes of ownership change that delegated partial use and cash-flow rights to stakeholders of mostly medium-sized firms and plants and gave them incentives to negotiate with one another and restructure assets. One route, “liquidation” sent firms through a bankruptcy procedure.<sup>33</sup> For instance, the most prominent liquidation route (Article 19) included 1464 firms or over 26% of all and 37% of non-agricultural firms subject to ownership transformations by the end of 1996. Although the details of the data lack clarity, previous research shows that as much as half of these assets of completed projects were partially restructured, kept as going concerns, and sold or leased to a combination of managers, workers, and outsiders.<sup>34</sup> The downside of these court-based proceedings has been their slowness – for instance, as of December 1996 about only 34% of Art. 19 projects were completed.

The other route, probably the most efficient and dynamic, came through Article 37 of the 1990 Law, and is commonly known as “direct privatization.”<sup>35</sup> This law allowed employee councils to legally dissolve the state firm and then have the assets be sold for cash or in-kind contributions or be leased to a new company, often comprised of insiders. By December of 1996, 1247 firms or over 22% of all and 31% of non-agricultural firms subject to ownership transformation entered direct privatization. Direct privatization accounted for almost 30% of all non-bank privatization revenues.<sup>36</sup> Over 40% of firms were in manufacturing. By the end of 1996, 97.9% projects in direct privatization were completed,

far surpassing the completion rates for “liquidation” and especially the “indirect privatization” paths of commercializing firms and then selling them case-by-case or via the voucher investment funds (14.9%).

The lease option has accounted for over two-thirds of direct privatization projects and by the end of 1995 accounted for more employees than those in the “indirect” path.<sup>37</sup> Lease contracts were 5-10 years, allowing stakeholders to gain full ownership over time and create a management-employee buyout (MEBO) through state-subsidized financing. The new company had to have at least 50% of employees of the original firm and make an initial down payment of 20% of book value. In return, it received a below market interest rate and could defer initial payments for up to two years. Research has shown that MEBOs and firms in direct privatization in general have performed well: the financial, productivity, and output indicators of the firms surveyed tend to be better than national and sectoral averages, and by 1998 only 23 MEBO firms had defaulted on their lease payments.<sup>38</sup> The studies also show that the majority of firms were undertaking organizational, process, and product innovations.

The use of Articles 19 and 37 for ownership transformation, particularly MEBOs, made three critical contributions toward network reorganization. First, as opposed to focusing solely on delineation of ownership rights, these routes made asset restructuring and the reordering of property rights simultaneous and gradual. Firms in Article 19 often received debt relief. Leasing arrangements effectively were incentive contracts that gave the new operators subsidized financing and tied the option for full ownership to the reorganization and efficient use of assets. In turn, both routes had the central and regional governments help share some of the risks of restructuring and provide breathing space for firms to experiment with new strategies.

Second, these routes set made multi-party negotiations and consultations necessary for linking restructuring and ownership change. For instance, Article 37 required that a majority

of employees approve the process and, for MEBOs, form the new company. Article 19, though apparently less efficient, effectively avoided zero-sum outcomes by forcing creditors (banks and suppliers) and managers to generate a basic restructuring plan and find a new owner that was willing to also accept the existing workforce. Given often the legacy of tight linkages between firms and plants and the use of social relationships among them to coordinate decisions, this implicitly meant a degree of inter-firm negotiation about such actions.<sup>39</sup>

Third, rather than cutting itself off from society and monopolizing power, the central government delegated authority to sub-national administrations to monitor financial assistance and enhance deliberations. For instance, the 49 voivodships (regional administrations) received responsibility over most firms as their “founders” and became central in facilitating dispute resolutions and consultations among firms. As the founder of an enterprise, the voivodship could initiate or block a liquidation petition, evaluated direct privatization projects before they were passed to the central Ministry of Ownership Transformation for final approval, and negotiated with MEOB candidates about certain terms of repayment. As such, the voivodship was negotiating with and mediating between the various stakeholders and competing claimants to assets. Moreover, as an agent of the central government charged with monitoring compliance with the various agreements, it collaborated with other public agencies, firms and banks to pool information and learn more about the activities and problems of firms in the region.<sup>40</sup> As we will now see in the next two sections, such activities were as much about building policy networks as they were about reorganizing existing firm and bank networks.

### **IIIb. Polish Privatization and Workouts of Large Firms**

As discussed at length elsewhere, the Polish central government played an active role in the creation of investment funds and the regulation of the capital markets.<sup>41</sup> But because of the



delays in the privatization of the largest firms and the slowness of the formal bankruptcy procedures, the government initiated a state-backed workout regime to deal with the growing stock of bad bank loans to firms. Whereas the Czech agenda of depoliticization limited bank restructuring to a one-time partial capitalization and debt-extraction of banks and firm restructuring to a function of rapid privatization and a strict bankruptcy law, the Polish government's workout regime purposefully tied bank and firm restructuring together. As such, the Polish policy was guided by the three principles just discussed: tying restructuring to gradual ownership transformation, creating government monitored mechanisms to promote extended deliberations on restructuring among parties to assets, and using public actors to share some of the risk of restructuring. The policy benefited firm creation by keeping a flow of resources to new SMEs and by helping relevant banks and firms reorganize their existing financial and operational ties.

In 1993, the Polish government launched the Enterprise and Bank Restructuring Program (EBRP). The Finance Ministry originally viewed EBRP as a way to address the growth of bad debts while prepping the large banks and firms for privatization and initiating debt-equity swaps. But intent on linking operational and financial restructuring of both the banks and the large firms, the Ministry altered the role of government. First, by initiating full-scale workouts, the government recognized that not only were market incentives and traditional bankruptcy regimes insufficient but also that it was also a key stakeholder in both firms and banks, not least of all due to its responsibilities as lender of last resort and as a creditor to both (via back taxes). Second, since linking the restructuring of both the banks and the firms demanded government review and monitoring of restructuring projects, the Finance and Privatization Ministries as well as the voivodships became extended participants as a financial partners and conflict mediators to the relevant groups of firms and banks.

The design of EBRP was rather simple. The government offered seven of the nine main commercial banks (which held about 60% of outstanding enterprise debt) a one-time recapitalization sufficient to deal with classified debts that originated prior to 1992. In return, the banks had to establish workout departments and had to reach a debt resolution agreement with its debtors by March 1994, to be fully implemented by March 1996. Such an agreement allowed for 5 paths, including demonstration of full debt servicing (about 40% of the 787 total firms), bankruptcy, liquidation, debt sale, and a new regime called “bank conciliation”. This last route became the most popular method of dealing with problem firms (23% of firms and 50% of debt) and has been widely judged as a successful, innovative policy that not only improved the financial and operational performance of banks and firms but also provided strong foundations for rejuvenating the governance of relations between financial institutions and firms.<sup>42</sup>

In bank conciliation the government, banks, and firms exchanged financial assistance for property rights and reorganizational actions. For the purpose of the paper, the policy and the process itself had two critical impacts on network reorganization. First, in linking restructuring of firms to debt relief, bank conciliation enhanced the ability of network actors to recombine mutual claims and SMEs to grow. On the one hand, the restructuring of large firm finances and operations provided a flow of resources and thus breathing space for large and their interconnected smaller firms to experiment with new uses of assets and new methods of contracting. Since bank conciliation forced operational restructuring, it provided a framework in which large firms could begin negotiations with suppliers and customers about initiatives in spin-offs, leasing, sub-contracting, and production changes. On the other hand, government intervention not only broke an existing stalemate between banks and firms, similar to that in the Czech Republic, but also provided a vehicle in which banks could learn more about serving clients and the problems manufacturing firms faced. For instance, in his

detailed analysis of the heavily industrialized Lodz region, Dornisch (1997, 2000) notes that perhaps the most important outcome of EBRP in general, and bank conciliation in particular, was that the regional bank learned how to tap back into inter-firm networks and use them to create what he calls “project networks” for more efficient ex ante and ex post monitoring of financing new and existing firms. The project networks were vital to the regional bank’s successful development of regional equity and venture capital funds.

Second, in using the principles of delegation and deliberation, bank conciliation helped both public and private actors learn how to use negotiated solutions of common asset problems and, thus, learn how to develop their new roles in network restructuring. For instance, bank conciliation was a conscious effort by the government to overcome market inefficiencies and centralized administration. The Finance Ministry first provided financial support to the banks (and to the firms under a separate agreement on unpaid taxes and wages) while delegating restructuring authority to them, mainly to a lead bank. The Ministry then set basic rules of restructuring criteria, termination dates, and negotiating principles to monitor bank and firm compliance. At the same time, as the “founders” of the firms involved, the Ministry of Privatization and the voivodships were well positioned to monitor compliance and forge compromises between the banks and firms. Within this structure, the banks and firms negotiated the terms of restructuring and in some cases (about 10%) debt-equity swaps. During implementation, the different public and private actors had to reveal regularly to one another information on the progress of their actions and thus begin to learn how to monitor one another and devise new roles for themselves.

Taken together, the direct privatization and EBRP policies facilitated negotiated solutions to network reorganization and project selection by having public actor at various levels of society and across different functions become interim financial partners to restructuring and utilize the principles of delegation and deliberation. To overcome first

mover problems, the central government delegated certain rights and resources to firm, bank and regional government actors to initiate and oversee restructuring activities. Rules guiding project approval and compliance forced these actors to periodically reveal information to one another, deliberate over the terms of financial assistance and restructuring, and evaluate one another's actions. Such a process is distinct from the depoliticization and continuity approaches. As opposed to property rights views, ownership and creditor rights are conditional and gradually defined as the government remains an active participant in restructuring. As opposed to statist views, the exact terms of financial assistance are developed through multi-party negotiations, and both national and sub-national government actors share monitoring responsibilities with one another as well with relevant firms and banks. As opposed to continuity views, direct privatization and EBRP aimed not simply to preserve existing networks, but rather break existing behavior while providing incentives and rules for network actors to reorganize the authority structure and operational relations among themselves.

### **IIIc. Local Government**

The importance of the interactive relationship between public actors and network restructuring can be brought into sharper focus when one considers a third fundamental difference between the Czech and Polish approaches to transformation: the role of regional and local governments. Both Polish and Czech reformers were highly concerned about continued control by communist apparatchiks of regional and local councils and maintaining a unitary state. But their methods of dealing with them contrasted sharply. As mentioned earlier, the Czech approach centered on concentrating power into an elite change team within the central government and debilitating local power. Consequently, regional governments were dissolved and reinstated only in 1998, while district level powers diminished and municipalities fragmented. In contrast, the Poles not only maintained the 49 regional

governments (voivodships) but also strengthened the role and accountability of local governments (gminas).<sup>43</sup>

Significantly different institutional settings have thus emerged.<sup>44</sup> The Czech Republic has fragmented into numerous, small and largely uncoordinated municipalities and weak districts. Poland's municipalities (gminas) are considerably fewer and larger, and are coordinated by voivodships. Although Czech and Polish municipalities have roughly similar aggregate revenue and expenditure structures, the Polish gminas and voivodships have significantly more autonomy on setting tax rates and in deciding the use of existing resources. For instance, whereas the Czech central government established only 2 Regional Development Agencies (RDAs) in the regions with the highest unemployment, the Polish voivodships and gminas had created 66 RDAs by 1996 throughout the country. While the Czech central government controlled virtually all aspects of privatization and restructuring policies (besides the auction of small shops and restaurants), voivodships and to some degree gminas were from the beginning given significant responsibilities, particularly in becoming the legal "founders" of many manufacturing firms. Indeed, the Polish gminas have been consistently cited for their improvement in services and their unique ability to create a vibrant municipal bond market. Moreover, recent research in Poland reveals high and strong correlations between the implementation of development policies and the density and diversity of public-private institutions in voivodships, on the one hand, and relatively high rates industrial restructuring, participation in direct privatization (especially via MEBOs), SME creation, and the reception of FDI on the other.<sup>45</sup>

One clearly should not overstate the impact on restructuring of a particular administrative law or budgetary indicator. Indeed, voivodships have also criticized in lacking local accountability via direct elections and sufficient financial resources and autonomy to aid economic restructuring.<sup>46</sup> Nonetheless, despite their limitations, voivodships and gminas

have proven to play important roles, less as profound managers of the economy and more as agents of institutional experimentation by becoming active participants and forums for strengthening and reshaping the network ties among firms, banks, and regional and local governments. This insight is critical when one considers that the Czech counterparts were literally or figuratively eliminated from playing any role in privatization and restructuring. In their separate but equally detailed and extensive research on the role of voivodships in industrial restructuring, Hausner and Dornisch show how voivodships were able to harness their limited, but nonetheless existing, political and organizational capital to revitalize informational, social and economic links among private and public actors.<sup>47</sup>

First, in exploring their legal roles as founders of many state firms and as overseers of regional development, voivodships were most effective when they focused first on becoming effective monitors of firms in their jurisdictions. To do so, they combined their relative authority and organizational resources with the social, informational, and human resources of regional banks, firms, consultants, gminas and the local offices of the central tax agency. These initial steps toward pooling diverse sources of knowledge and information became first and foremost a resource for economic actors to expand their portfolios of strategies, collaborators and project screening capabilities. For instance, when EBRP was launched, the regional banks lacked effective monitoring capabilities. In turn, they began to supplement their deficiencies by participating in regular regional council meetings and accessing the voivod data base, particularly on the firms that were in EBRP and had the voivodship as its founder. In return, the banks began to consider the strategic goals of the voivodship, regional labor bureau, and the tax authority regarding the firms directly and indirectly under their control.

Second, this interaction via information sharing allowed participants to begin to learn about one another's capabilities and interests and define some basic areas to of joint action

and risk and resource pooling. For instance, the pilot experience in restructuring firms in EBRP, and in some case becoming co-owners of them, led the Lodz Bank and Voivodship to co-manage a closed World Bank investment fund for initially 20 firms. A tie such as this fortified horizontal links among related public and private actors.

Third, it is vital to note that these developments were gradual and often initiatives failed. But it was the continued presence and efforts of the voivodships and gminas as well as the impulse coming from programs like EBRP and direct privatization that allowed the actors to learn from the failure and recombine pieces of the potential inter-organizational networks. Learning came not simply about how to evaluate a particular project but also from how to define a reasonable set of common projects and how to assess one another's actions and contributions. As Dornisch emphasizes in his analysis of the revitalization of Lodz, a voivodship that went from being a rust belt to one of the most vibrant regions of SME development and restructuring, learning about project selection was intimately connected to learning how to monitor one another and share authority over common assets. Just as private and public actors were assessing the prospects of new projects, they were also gaining experience about what were the most effective roles one another could play.

#### **IV. Concluding Remarks**

This essay has argued that an *embedded politics* approach may prove more useful than depoliticization and continuity approaches in analyzing restructuring and firm creation, at least in East Central Europe. In my approach, socio-political networks mediate between two simultaneous, interdependent experiments -- micro-level experiments by firms and banks to reorganize common assets and macro-level experiments by policy-makers to build new institutions. The restructuring of networked assets demand institutional workout mechanisms that help the different claimants negotiate over time the redistribution of risk and property rights. Since public actors are both constituents to networks and often key players in such

institutions, restructuring in turn depends on the ways that different national and sub-national organs are given the legitimacy and resources to explore their roles as risk-sharers, initiators, and monitors of the negotiations.

At one level, inter-linked firms and banks are attempting to learn how construct new formal and informal methods of mutual monitoring and project selection. This is where asset restructuring is tied to network reorganization. At another level, public actors, be they the central agencies or regional governments, are learning how to provide financial and organizational support to firms and banks while experimenting with different ways to monitor the latter. In turn, the embedded politics approach argues that public actors are most effective in combining learning and monitoring, for themselves and for economic actors, when transformation policies are based on the principles of delegation and deliberation, rather than simply on the notions of autonomous, strong states, private property rights, or public spending.

This essay has tried to show that Poland created political conditions more conducive for institutional experimentation. Czech impediments to institutional experiments came not only from the government's attempt to rapidly privatize firms and banks but also from its attempt to create and maintain an autonomous, powerful central policy-making apparatus. In contrast, Poland's relative economic success came from economic policies that linked the reorganization of assets with gradual ownership change as well as institutional policies that gave a variety of government actors the resources and discretion to participate in restructuring.

In trying to connect the politics of institutional change to economic restructuring, my argument invites two areas of additional scrutiny. First, one may argue that Poland's success was mainly due to Solidarity's historical grass roots organizational network that believed that strengthening local democracy was vital to negating the legacy of communist centralism. I



do not doubt or want to underestimate the importance of Solidarity. But to the extent that this is true, one must not only discard the idea that economic reform can only occur if the political power of such groups is diminished but also account for the many changes that took place within Solidarity. Similarly, there is no reason to think ex-ante that other countries lack various forms of social and political organization or that social structures remain unchanged. The challenge is showing how changes in social structures inter-act with alterations in political power.

Second, although my argument may resonate with the current debate on the relationship between development and federalism, my emphasis is slightly different.<sup>48</sup> My discussion of the importance of sub-national administrations is not meant to argue that prosperity can only come to large nations governed by federalist structures. Rather, my discussion meant simply to illustrate that institutional experimentation requires, at a minimum, the empowerment of a variety of government actors to explore different policy approaches and have the political voice to relay them back to higher-level bodies. Even in small countries, central governments can easily become overburdened with multiple conflicting demands, and sub-national administrations will likely have the political capital and information to adapt general policies more rapidly to local circumstances. The issue, then, for research on economic and institutional development in emerging democracies is not simply whether central governments have ex-ante the “right” policy designs or the “right” combination of autonomy and coherence. Rather it is how central governments can aid sub-national and subordinate administrations to pursue experiments with public-private institutions while developing adequate means of governance to limit the dangers of creating massive regional disparities and, as they say in Argentina, local *Caudillos*. It is in this vein that the governance principles of delegation and deliberation may turn the potential for local abuse and self-dealing between public and private actors into benefits for the public welfare.

**Table 1: Divergence in Privatization (1995)**

	<b>% of GDP in Private Hands</b>	<b>% of firms in Private Hands</b>	<b>% of Industrial Output in Private Hands</b>	<b>% of Bank Assets w/in State Banks</b>
<b>Czech Republic</b>	70	90	93	19.5
<b>Poland</b>	60	46	60	71.1

Sources: EBRD (1996), Pohl et al. (1997), World Bank (1996), Tang et al. (2000)

**Table 2: Divergence in SME Growth in Manufacturing**

Firms with Less than 250 Employees\*

	<b>Czech Republic (1995)</b>	<b>Poland (1997)</b>
Share of Employment (%)	<b>35%</b>	<b>52.5%</b>
Share of Sales (%)	<b>29.5%</b>	<b>37%</b>

Sources: Zemplerova (1998), Polish Foundation for SME Promotion and Development (1999).

\* -- In 1989, the SME share of manufacturing employment for Poland was about 10% and for Czechoslovakia about 1%. See Acs and Audretsch (1993).

**Table 3. Key Economic and Financial Indicators for the Czech Republic and Poland**

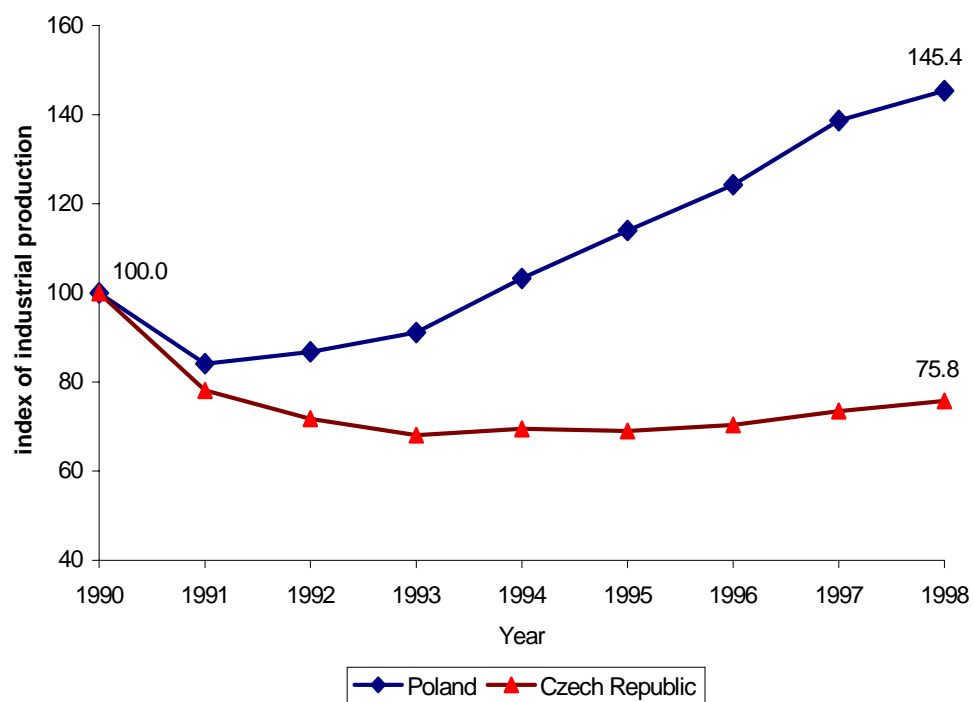
	<b>Change in Real GDP, 1989-98</b>	<b>Change in Industrial Labor Productivity, 1989-98</b>	<b>Budget Deficit/GDP</b>		<b>Foreign Debt/GDP</b>		<b>Debt Service/Exports</b>	
			<b>1992</b>	<b>1998</b>	<b>1992</b>	<b>1998</b>	<b>1992</b>	<b>1998</b>
<b>Czech Republic</b>	-4%	+13.6%	3.1%	1.6%	23.0%	44.7%	12.0%	14%
<b>Poland</b>	+17%	+42.2%	6.7%	2.4%	57.7%	27.1%	16.0%	9.0%

Sources: Kawalec (1999), Business Central Europe (Selected years at [www.bcemag.com](http://www.bcemag.com))

**Table 4. Contrasting Approaches to Building Workout Mechanisms in Manufacturing**

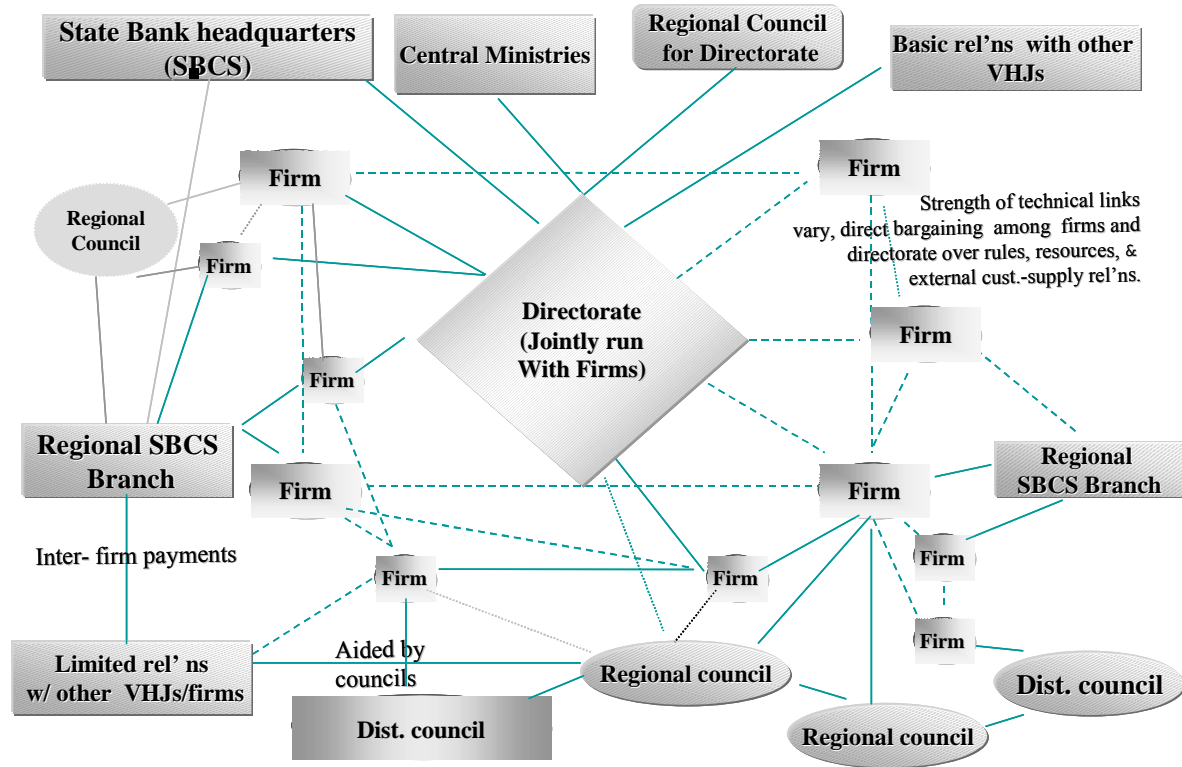
<b>Policy Issue</b>	<b>Czech Republic</b>	<b>Poland</b>
Ownership Change	Rapid, Mass Privatization via Vouchers.	Gradual methods linked with restructuring, mostly via “liquidation” and “direct” privatization, esp. until 1996.
Bank Restructuring	One-time partial debt write-off & recapitalization.	Enterprise Bank Restructuring Program (EBRP), 1993-96, links bank and large firm restructuring.
Firm Restructuring	<ul style="list-style-type: none"> <li>- Contracts and strict bankruptcy law focused on liquidation</li> <li>- Failed attempt to net-out inter-firm debt.</li> </ul>	<i>Large Firms</i> – EBRP.
		<i>Medium &amp; Small Firms</i> – “liquidation” and “direct” methods of privatiz’n (e.g., leasing).
Organization of Policymaking  - <i>National Level</i>	Strong, autonomous change team in Mins. of Finance & Priv’n focus of rapid implementation of vouchers, bank recapitalization, and new laws.	Mins. of Finance & Priv’n build capabilities to initiate and monitor EBRP & gradualist methods of priv’n; Build strong regulations for capital market; Give roles to sub-nat’l gov’ts.
- <i>Sub-national Levels</i>	<ul style="list-style-type: none"> <li>- Regional councils eliminated;</li> <li>- Districts and Municipalities fragmented and weak.</li> </ul>	<ul style="list-style-type: none"> <li>- Voivodships (regional gov’ts) empowered to screen and monitor priv’ns, assist in EBRP, build RDAs;</li> <li>- Gminas (municipalities) work with Voivodships on restructuring, RDAs and bond market.</li> </ul>

**FIGURE 1. Industrial Production in the Czech Republic and Poland**



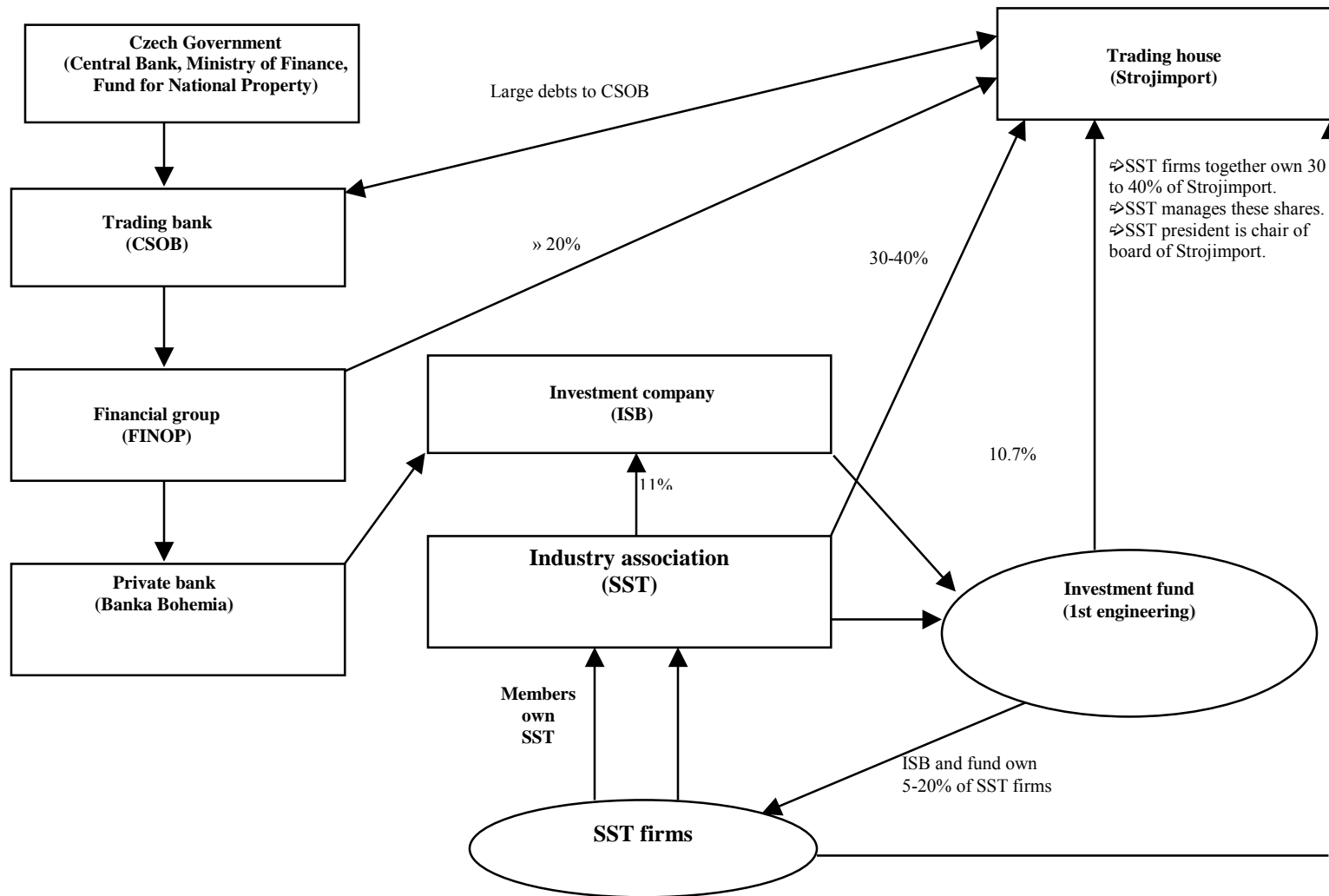
Source: OECD (1999) in Spicer et al. (2000)

**Figure 2: Polycentric Network (e.g., TST VHJ)**



Source: McDermott (2002, Chapter 2).

**FIGURE 3: Network Ties in the Czech Machine Tool Industry**



Note: Direction of arrow denotes direction of ownership  
Percentages denote ownership share.

Adapted from McDermott (2002, Chapter 5).

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## Endnotes

<sup>1</sup> For the similarities between neo-liberal and statist views to transformation, see Moon and Prasad (1994), Hayri and McDermott (1998), and McDermott (2002). Separately these views can be found in Kirzner (1973, 1997), North (1990), Boycko, Shleifer, and Vishny (1995), Sachs (1990, 1993), Frydman and Rapaczynski (1994), Haggard and Kaufman (1992, 1995), Amsden (1992, Amsden et al. (1994), and Evans (1995).

<sup>2</sup> For the application of this approach to post-communist countries, see Stark (1990, 1992, 1996), Stark and Bruszt (1998), Ekiert (1996), Hausner, Jessop, and Nielson (1995), Chavance and Magnin (1997), and Spenner et al. (1998). More general arguments on continuity and social capital can be found in Putnam et al. (1993) and Ostrom (1995).

<sup>3</sup> Although Czechoslovakia (CSFR) split in January 1993, I focus on the Czech Republic. There was strong continuity in policy for the Czech lands before and after the split, as the main economic policy makers for the CSFR and the Czech Republic remained largely the same. All firms analysed below were always part of the Czech lands as well. The network, firm and institutional data for the Czech Republic come from mainly my field work between 1993 to 1996, during which time I conducted over 130 interviews with relevant ministerial, bank, and firm actors and collected primary and secondary firm, bank, and sectoral level data. (See McDermott, 2002) The Polish data come mainly from secondary sources cited below as well as a series of conversations with researchers at the CASE Foundation in Warsaw.

<sup>4</sup> See McDermott (2002) for a discussion of depoliticization views as they appear in economics, rational choice, and developmental statism. My critique draws on observations by Mood and Prasad (1994), Grindle (1991), and Murrell (1993). For Economistic version, see Olson (1992), Murrell and Olson (1991), Boycko et al. (1995), Shleifer and Vishny (1994), Frydman and Rapaczynski (1994), Lipton and Sachs (1990 a,b), Sachs (1990, 1993), Camdessus (1995), and World Bank (1996). Developmental statist version are evident in Amsden (1992), Amsden et al. (1994), Haggard and Kaufman (1992, 1995), and Evans (1995).

<sup>5</sup> Discussions on the formation of policy and the conditions in the CSFR and CR and on the optimal conditions for reforms in general can be found in McDermott (2002, Chapter 3), Hayri and McDermott (1998), OECD (1996), World Bank (1996), Frydman and Rapaczynski (1994), Moon and Prasad (1994), Haggard and Kaufman (1992, 1995) and Amsden et al. (1994). In my analysis of both countries, I am only concerned with so-called large privatization program, and not with the privatization of shops and restaurants or by restitution.

<sup>6</sup> For discussions of the different social, political, and economic conditions and policies in Poland, see World Bank (1996), Frydman and Rapaczynski (1994), Dabrowski et al. (1992), Levitas (1994), Stark (1992), Stark and Bruszt (1991, 1998), Ekiert and Kubik (1999), Murrell (1993), Dornisch (1997), Przeworski (1991), and Lipton and Sachs (1990 a,b).

<sup>7</sup> See, for instance, Frydman and Rapaczynski (1994), Boycko et al. (1995), World Bank (1996), Nellis (1999), Camdessus (1995), EBRD (1995).

<sup>8</sup> See the studies by Bratkowski et al. (1999) and EBRD (1995).

<sup>9</sup> Although surveys by the EBRD (1995) and OECD (1996) show Czech SMEs having a greater share of employment and GDP, most of the growth in Czech SMEs were in trade, tourism and some services. (Zemplerova (1995, 1998). These are hardly sources of long-term growth and stability. Moreover, mainstream studies of SMEs focus on the manufacturing and tradable sectors (Acs and Audretsch (1990, 1993). See Blaszczyk and Woodward (1999) and Klich and Lipiec (2000) on the contribution of SMEs to growth in Polish industry.

<sup>10</sup> For U-turns by its advocates, see World Bank (1999), Sachs (1999), Johnson and Shleifer (1999), and Nellis (1999). For other critiques, see Coffee (1995, 1999), Spicer et al. (2000), and McDermott (1997, 2001).

<sup>11</sup> For data and analyses of the bank restructuring, bad debts, and the bankruptcy laws, see Tang et al. (2000), Hoshi et al. (1998), and McDermott (2002, Chapter 3).

<sup>12</sup> See Johnson and Shleifer (1999).

<sup>13</sup> See Jarosz (1999), Blaszczyk and Woodward (1999), Blaszczyk (2000), and Kaminski (2000).

<sup>14</sup> See in particular Chapters 3-5 of Johnson and Loveman (1995). Kornai (1990) and Murrell (1993) were among the first to argue that growth would come from new SMEs that emerged in part from the second economy under communism. One of the few multi-country econometric analyses of de novo firms suggests a relationship between SMEs growth and state sector restructuring (Bilsen, 1998). Indeed, the work on the second economy stressed a how

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the creation of private and quasi-private small firms was interwoven into the operations of state firms. See Gabor (1989, 1990), Szelenyi (1988), Seleny (1991) and Stark (1986, 1989).

<sup>15</sup> See, for instance, Granovetter (1985), Nohria and Eccles (1992), Powell (1990), Uzzi (1996, 1997), Rowley et al. (2000), Kogut (2000), and Kale, et al. (2000). For analysis on the relationship between different types of networks and entrepreneurship, see Larson (1992) and Burt (1992).

<sup>16</sup> Stark (1986, 1996, 1999), Stark and Bruszt (1998), and Grabher and Stark (1997). See Sedatis (1997) for a network approach to Russian entrepreneurs and Spicer et al. (2000) on a network view of the impact of privatization on entrepreneurship in East-Central Europe. Related works on social capital are Putnam et al. (1993) and Ostrom (1995).

<sup>17</sup> See World Bank (1999), Coffee (1995), and McDermott (2002, Chapters 3 and 4) for analyses of the collective action problems that the dominant funds and banks faced in investing into firms and that firms faced when even offered subsidies to cancel out inter-firm debt. For instance, in 1994, the government withdrew a 1 Bill Kc program for relieving inter-firm debt. After 8 months of operation, the program reduced inter-firm debt by less than 10%.

<sup>18</sup> Note that this approach departs from also Durkheimian and rational choice views on social capital and institutions, because of their similar focus on continuity and static nature of social structures. See for instance, Putnam et al. (1993), Ostrom (1990, 1995), and Knight (1992).

<sup>19</sup> See for instance, Saxenian, 1994; Locke, 1995; Piore and Sabel, 1984; Sabel and Zeitlin, 1994; Herrigel, 1996; and Grabher 1993.

<sup>20</sup> For work on the former USSR, Poland, GDR, and Hungary, see, for instance, Prokop (1996), Woodruff (1999), Dornisch (1997, 1999), Jacoby (2000), Seleny (1993), Szelenyi (1988), and Levitas (1993, 1999). Even within the work of Stark and Bruszt (1998), there are strong suggestions of the interconnection between local political actors and managers (see, for instance, Chapter 4).

<sup>21</sup> Hayri and McDermott (1998) and McDermott (1997, 2002).

<sup>22</sup> For insightful analyses on the development of US institutions for bankruptcy, limited liability, insurance, and lender of last resort, see Cui (1995), Moss (1996a,b, 1998), and Berk (1994). See Coffee (1999) and Pistor (1999) for insightful arguments about why the issue of law in practice and regulatory regimes may be the crucial issue for capital market development in East-Central Europe.

<sup>23</sup> Note that the argument here about the relationship between continuity and change and the role of sub-national governments in many ways reflects recent work on explaining Chinese growth. See, for instance, Oi (1999) and Cao et al. (1999).

<sup>24</sup> McDermott (2002, Chapter 2) gives a brief history of the Czech machine tool industry. The Czech machinery and equipment sector is classified as NACE 29. OKEC-NACE is the Czech classification system that roughly corresponds to SIC. Division 29 includes: (291) manufacture of machinery for the production and use of mechanical power, (292) manufacture of other general purpose machinery, (293) Manufacture of agricultural and forestry machinery, (294) manufacture of machine tools, (295) manufacture of other special purpose machinery, (296) manufacture of weapons and ammunition, (297) manufacture of domestic appliances n.e.c. While most firms discussed below are in NACE 294, some are in 295. As late as 1997, even with the decline of industrial employment and output, these industries and the sector as a whole remained at the heart of Czech manufacturing. For instance, NACE 294 and 295, respectively, accounted for 11% and 29% of sales within NACE 29. NACE 29 as a whole accounted for almost 15% of total manufacturing employment (the largest of the 11 sectors in manufacturing) and about 12% of total manufacturing value-added (second only to food processing). See publications and data by Ministry of Industry and Trade of the Czech Republic, 1998, at <http://www.mpo.cz>.

<sup>25</sup> See, for instance, Piore and Sabel (1984), Herrigel (1996), Friedman (1988), Carlsson (1989), Carlsson and Taymaz (1994), Acs, Audretsch and Carlsson (1991), and Acs and Audretsch (1990).

<sup>26</sup> The following analysis of the machine tool network is based on McDermott (2002, Chapters 2 and 5). An analysis of other branches that possess tightly integrated, hierarchical networks can be found in McDermott (2002, Chapters 2 and 4) and in Hayri and McDermott (1998).

<sup>27</sup> See, in particular, Rowley et al. (2000), Kogut (2000), Larson (1992), Uzzi (1996), Locke (1995), Burt (1992, 1998), Kale, Singh, and Perlmutter (2000).

<sup>28</sup> See Larson (1992), Rowley et al. (2000), and Burt (1998) for the ways these apparently opposing traits can be optimal for firms in turbulent conditions and entrepreneurial settings.

- <sup>29</sup> The variation in the stake held by SST in Strojimport is due to changes in the structure in the firm and to ongoing negotiations about share price. As the network fragmented (see below), SST firms ultimately returned the shares to the state. Also, given the shareholding regulations and dispersion of ownership in the Czech Republic, the 3-20% equity stakes acquired by ISB enabled SST, on behalf of ISB, to gain a seat on the management or supervisory board of the respective firms.
- <sup>30</sup> A similar fate met the vocational training system, which severely hurt the ability of member firms to retain existing craftsmen and train new ones. Vlácil et al. (1996) show that the combination of the government policy to make training centers self-financing and the liquidity constraints of machine tool firms led to the virtual collapse of vocational training in the industry.
- <sup>31</sup> The problems of spin-offs were common to other industries as well (Hayri and McDermott, 1998). Indeed, econometric analysis shows that there were relatively few cases of Czech industrial spin-offs, and they performed substantially worse than their former parent firms. (Kotrba, 1994; Lizal, Singer, and Svejnar, 1995)
- <sup>32</sup> A more detailed discussion on delegation and deliberation can be found in McDermott (2002). Although Stark and Bruszt (1998) embrace similar forms of deliberation, their discussion is disconnected from producing change at the micro-level and tends to be undermined by their use of punctuated equilibrium. My discussion also draws on Cohen and Sabel (1997) and Sabel (1993, 1994).
- <sup>33</sup> I am speaking here mainly of Article 19 of the 1981 Law on State enterprises that was incorporated into privatization policy and to a lesser degree the amended 1934 Bankruptcy Act. See Blaszczyk and Woodward (1999) and Nuti (1999) for data on privatization. As of December 1990, there were 8441 state enterprise. By December of 1996, 5592 enterprises had entered a track of ownership transformation, and 662 of these firms had entered the process of the 1934 Bankruptcy Act.
- <sup>34</sup> See Gray and Holle (1998a) and Blaszczyk (2000). I also confirmed this estimate with the research team at CASE Foundation, Warsaw.
- <sup>35</sup> See Jarosz (1999), Nuti (1999), and Blaszczyk and Woodward (1999) for details.
- <sup>36</sup> This figure is generated from total non-bank privatization revenues through the direct and indirect paths of privatization. See Jarosz, p. 35, Table 4 (1999).
- <sup>37</sup> By the end of 1995, leased firms accounted for over 170 thousand employees, whereas firms in indirect privatization accounted for about 158 thousand employees. See Blaszczyk (2000).
- <sup>38</sup> There were two major systematic studies of 200 of these firms (across industries and regions) in 1995 and 1998 (Jarosz, 1996, 1999). One drawback has been the slow rate of investment, largely due to the lack of immediate ownership of the assets. See also the study by Kozarzewski and Woodward (2000).
- <sup>39</sup> See Dornisch (1997).
- <sup>40</sup> See Jarosz (1999, Chapters 2, 4, 10), Dornisch (1997, 1999) and Hausner, Kudlacz, and Szlachta (1995, 1997, 1998).
- <sup>41</sup> See Coffee (1999), Pistor (1999), and Johnson and Shleifer (1999).
- <sup>42</sup> See Van Wijnbergen (1997), Gray and Holle (1998b); Dornisch (1997, 2000); Montes-Negret and Papi (1996). I draw on these works for the following paragraphs as well.
- <sup>43</sup> A central tenet of Solidarity was strengthening local democracy to combat communist centralism. As Levitas (1999) argues, this tenet became used by different factions of Solidarity to limit the centralism of the Balcerowicz plan.
- <sup>44</sup> See OECD (1996b), Hausner et al (1995, 1998), Domanski (1998), Baldersheim, Illner, Offerdal, Rose, and Swianiewicz (1996), Blazek (1993), Levitas (1999). The basic structural differences are stark. For instance, the number of Czech municipalities grew by 50% by 1991 to 6237 with an average size of 1700 inhabitants, while Polish gminas maintained most of their integrity (2466 gminas with average size of 15,000 inhabitants). While Czech and Polish municipalities have similar, proportional financial data, the Polish gminas were given significantly more autonomy on the use of funds and organizational resources to pursue, i.e., investment, infrastructure, regional development, etc. For analyses of Regional Development Agencies in the region, see Halkier, Danson, and Damborg (1998).
- <sup>45</sup> On these issues, see OECD (1996b), Hausner et al. (1995, 1997, 1998), Dornisch (1997, 1999, 2000), and Jarosz (1999). See Levitas (1999) for an examination of gmina finances.

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<sup>46</sup> For instance, voivodships have often been viewed as an arm of the central government, which appoints the governor, controls its budget, and restricts autonomy in the use of funds. They were reorganized in 1999, with provision made for the election of the governor. (See Hausner et al. (1995, 1997), Levitas (1999), OECD (1996b), and Dornisch (1999, 2000).

<sup>47</sup> For the following discussion, see Hausner et al. (1995, 1997), and Dornsich (1997, 1999).

<sup>48</sup> I have discussed the relationship between local economic development and federalism elsewhere (McDermott, 2001). See also related federalist debates in Cohen and Sabel (1997), Garman et al. (2001), Montinola et al. (1995), Oi (1999), Woodruff (1999), and Roddan and Rose-Ackerman (1997).