

# Problems and Environment of Small Businesses in the Czech Republic

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**ABSTRACT.** The impressive and spontaneous build-up of the private small and medium-sized enterprises (SMEs) in the Czech Republic in 1990–93 coincided with the similarly dramatic changes in the public administration and in the whole environment for decision-making. The resulting problems of SMEs in the Czech Republic seem to be common to all economies in transition. A lot of the problems are caused by the macroeconomic policy for which this sector is not the most important part of the national economy. The paper shows some conflicts between macroeconomic anti-inflationary (monetary and fiscal) policies, and interests of small businesses. The authors stress the importance of SMEs during the period of transition. Informal aspects of the functioning of small firms are discussed, especially their relation with banks and public administration. The paper offers some empirical evidence and available statistics on SMEs developments during 1990–94 focusing particularly on manufacturing.

## 1. Private sector and SMEs

Throughout this paper we are concerned with that part of the private sector which shows features of effective ownership, i.e. has stabilized ownership and solved personal responsibilities for the enforcement of property rights. It also implies that the principal, as an effective owner, is in control of decision-making and management. As opposed to the corporate sector, which in the Czech Republic was privatized mainly by the voucher give-away scheme, these conditions are satisfied in the majority of SMEs. Finally, we concentrate exclusively on the small firms, including the private non-coop agricultural sector, and the limited liability companies which often represent the newly born medium-sized businesses.

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The Czech private sector, the small and medium businesses and their entrepreneurship, have expanded with unprecedented speed between 1990–93. Even though the official estimates confirm their booming development, a significant part of the private activities have not been recorded and escaped the statistics. A cautious estimate may be made that the share of the effective private sector (the corporate sector privatized by the first wave of the voucher scheme excluded) on the GDP in 1993 may have reached at least 35%. This is, perhaps, slightly higher than what can be inferred from the official figures. The available official estimate of 44% for 1993 (see Table I) includes the cooperatives and the enterprises privatized by voucher privatisation. Naturally, the shadow economy is not included in the official statistics.

TABLE I  
Share of the non-state enterprises in GDP

| Year | Share of non-state sector <sup>a</sup> |
|------|--|
| 1989 | 11.2%                                  |
| 1990 | 12.3%                                  |
| 1991 | 17.3%                                  |
| 1992 | 20.2%                                  |
| 1993 | 44.0%                                  |
| 1994 | 56.3%                                  |

<sup>a</sup> Includes also the coops share of which is estimated for about 8%.

Source: Statistical information, Czech Statistical Office.

According to official statistics small and medium-sized enterprises perform better than large ones. While industrial production declined by 10.6% in 1992 compared to previous year, in the small business sector alone (industrial companies with less than 25 employees) only the production grew by 17.6% during the same period. While

during 1992 the labour productivity in Czech industry decreased by 2.3% compared to 1991, in the sector of businesses with less than 25 employees the labour productivity increased by 360% (see *Ekonom* No. 25, 1993, p. 17). These trends continued in 1993.

Even though a high degree of this success must be attributed to the governmental macroeconomic and privatization policy, the essential element was the spontaneous motivation of the population to use their own capacity and resources in organizing their livelihoods. The legacy of past entrepreneurial animal spirits (both capitalist and socialist) played a key role in the revival of private business. At the beginning, its most important barrier was the lack of individual endowments of physical capital and difficult access to financial capital.

There are only sporadic papers describing the environment from which indigenous entrepreneurship is born, and in which it is supposed to make decisions in order to survive or expand. The newly created small businesses are especially insufficiently covered, many of which have been established as start-ups on a green field. Their conditions are often very different from those of privatized state companies and corporations or surviving state enterprises. This paper attempts to unveil a part of that environment, as observed from our own experience and from communication with various entrepreneurs who have become increasingly visible during the recent few years of transition.

Small and medium sized enterprises (SMEs)

play a distinctive and irreplaceable role in any transition to the market economy. Other than directly contributing to GDP, small business development has several positive social effects which can be classified under the provision of public goods. The externalities of the spontaneously functioning small businesses are shared by the whole society (see Benáček, 1994). It is the medium, small and micro businesses and their hidden shadow components which should be rated as one of the most important determining factors affecting almost immediately the development in an economy undergoing the transformation from a command to a market system. If we accept the reasoning that the SMEs as public goods provide external social benefits which cannot be commercially rendered by other autonomous business activities and that these benefits are of exceptional importance during the times of transition, then it would be expected that the conditions for the development of the SMEs would become the focus of fundamental interest for the government, or for other institutions representing the State, and their economic policy.

The most important official statistics for a direct estimate of the number of practising entrepreneurs in the Czech Lands is the Register of firms in the Czech Statistical Office, on which the Table II is based. Its statistics in January 1993 assessed the total number of registered entrepreneurs at almost one million persons, which would represent more than 20% of the whole labour force of the Czech Republic. If we add to this number

TABLE II  
Number of firms according to the legal form

|                           | Total     | From these selected legal forms |                       |                                       |
|---------------------------|-----------|---------------------------------|-----------------------|---------------------------------------|
|                           |           | State enterprises <sup>c</sup>  | Joint stock companies | Individual entrepreneurs <sup>a</sup> |
| January 1990              | 18,837    | 1,576                           | 46                    | —                                     |
| January 1991              | 178,993   | 3,505                           | 658                   | 124,455                               |
| January 1992              | 955,647   | 3,737                           | 2,541                 | 891,872                               |
| January 1993              | 1,118,637 | 3,272                           | 4,076                 | 982,075                               |
| January 1994 <sup>b</sup> | 921,335   | 2,462                           | 4,819                 | 785,743                               |
| October 1994              | 1,085,446 | 1,827                           | 5,847                 | 911,302                               |

<sup>a</sup> Until January 1, 1992 at per trading act No. 105/1990 Coll. about private entrepreneurship of citizens, later at per Trading act.

<sup>b</sup> By December 1993, or January 1994 respectively reorganisation of the register of companies has been carried out using the taxation statistics.

<sup>c</sup> The number of state enterprises grew in 1990–92 due to the split of the enterprises.

Source: Czech Statistical yearbook 1994, data from Czech Statistical Office (CSU), 1994.

those of their working family members and other employees who take part in the business decision-making, we can estimate that approximately 30% of the Czech labour force may be fully or partially associated with entrepreneurial activities in the private sector with stabilized ownership and property rights. If the estimates of the 'grey' or 'black' economy were included (see Benáček (1994)), this figure could reach up to 40% of the labour force. These estimates imply that the boom in the SMEs was the most dynamic economic factor generating the dramatic changes and a surprising stability in the new capitalist developments which were initiated practically from scratch in November 1989.

Most of the new private firms have been established in the sector of trade, paid services and construction – See table III. Surprisingly a lot of new small firms started businesses also in manufacturing. As Table IV shows, in 1993 the small businesses with the number of employees above 24 contributed by approximately 10.6% to the manufacturing output. One should realize that in 1989 the manufacturing firms with less than 100 employees were practically non-existent because the central planning concentrated in developing the large-scale corporate sector only.

The Czech SME sector has expanded enormously during 1990–93. Within a mere four years it has converged very closely to the industrial structures common in Western Europe. Table V compares the number of firms in the Czech Lands with 10 million inhabitants and Austria with nearly 8 million inhabitants. Even though the Czech firms with more than 100 employees are still significantly more numerous, the convergence to nearly identical firm-size structure is apparent.

## 2. Conditions for emerging entrepreneurship

Let us now describe the type of environment, procedures and risks which challenged a standard entrant into a small or medium sized Czech business in 1992–93. In our hypothesis, reflecting the basic statistics characterizing the Czech situation in asset endowments in 1991–92, we may assume that our 'standard entrant' commands just the average stock of saved money per capita (Kč 40,000 = \$1,300), average wealth (owns some real estate worth Kč 300,000 = \$11,000), has past career neither in the group of former black marketeers nor in nomenclature, has entrepreneurial skills significantly above the average, is able to work 14 hours a day and 7 days a week,

TABLE III  
Enterprises according to their size and to their sector in the economy (as of October 1994)

| Sector                   | Percentage share of enterprises in the size group by number of employees |        |       |                    |
|--------------------------|--|--------|-------|--------------------|
|                          | 1–24   | 25–500 | > 500 | Total <sup>a</sup> |
| Agriculture and forestry | 86.1   | 13.6   | 0.3   | 99,470             |
| Mining                   | 67.5   | 19.9   | 12.6  | 927                |
| Manufacturing industry   | 92.7   | 5.8    | 1.5   | 165,584            |
| Gas and water supply     | 54.7   | 35.2   | 13.3  | 1,451              |
| Construction             | 88.9   | 11.7   | 0.4   | 122,064            |
| Trade                    | 96.3   | 13.6   | 0.1   | 356,012            |
| Transport and communic.  | 94.4   | 4.8    | 0.8   | 40,840             |
| Money and banking        | 93.3   | 6.1    | 0.6   | 5,698              |
| Paid services            | 93.1   | 6.3    | 0.6   | 172,698            |
| Public administration    | 79.0   | 18.9   | 2.1   | 9,365              |
| Education                | 51.6   | 47.7   | 0.7   | 12,971             |
| Health care              | 93.3   | 5.9    | 0.8   | 24,664             |
| Others                   | 90.4   | 9.3    | 0.3   | 73,702             |
| Total                    | 91.2   | 8.3    | 0.5   | 1,085,446          |

<sup>a</sup> Incl. firms, which do not record number of employees. There are only 24% out of the total number of firms registered by the Czech Statistical Office, which record the number of employees. The rest, which do not provide this information, are mainly very small firms or firms which may not be active.

Source: Authors' calculations based on the enterprise data from the Czech Statistical Office.

TABLE IV  
Share of small businesses in the total output of  
manufacturing, 1992–1993<sup>a</sup>

| Industry                | Share in total output <sup>b</sup> |       |
|-------------------------|------------------------------------|-------|
|                         | 1992                               | 1993  |
| Foodstuffs              | 8.5%                               | 14.7% |
| Tobacco                 | 0.0%                               | 0.0%  |
| Textile                 | 3.0%                               | 4.9%  |
| Clothing                | 15.0%                              | 27.0% |
| Leather and shoes       | 2.0%                               | 4.7%  |
| Wooden products         | 24.6%                              | 38.7% |
| Paper                   | 2.3%                               | 3.5%  |
| Printing and publishing | 23.0%                              | 33.7% |
| Oil and coal processing | 0.3%                               | 0.5%  |
| Chemicals               | 2.8%                               | 4.0%  |
| Rubber and Plastics     | 9.4%                               | 11.6% |
| Non-metal               | 6.5%                               | 8.2%  |
| Metal products          | 0.4%                               | 0.6%  |
| Metal construct.        | 17.4%                              | 24.6% |
| Machinery               | 3.2%                               | 4.6%  |
| Business machines, PC   | 7.8%                               | 10.5% |
| Electrical machines     | 8.4%                               | 16.1% |
| Communication equipment | 9.9%                               | 14.7% |
| Optical, medical instr. | 9.0%                               | 17.0% |
| Cars and trailers       | 1.6%                               | 1.4%  |
| Other transport         | 0.6%                               | 1.2%  |
| Furniture               | 11.9%                              | 17.6% |
| Recycling               | 13.3%                              | 14.7% |
| Total                   | 6.4%                               | 10.6% |

<sup>a</sup> Enterprises with fewer than 25 employees 1992.

<sup>b</sup> Total output of an industry, including the output of enterprises with more than 25 employees.

Source: Authors' calculations based on the enterprise data from the Czech Statistical Office.

and is determined to comply with the tax and other legal regulations. He or she also possesses higher entrepreneurial aspirations and does not want to run a self-employed, one-person business with no legal status and little capital requirement.

#### A. Registration and licensing for entry

Formal entitlement to any new business entry starts with registration and licensing for the given type of expected activity. The decision is exclusively in the hands of the district council pertaining to the residence of the applicant. A licence is granted for each required activity from a list of approximately 300 classified entries, so that a standard business has to apply for several of them. The fees are Kč 2,000 for each business activity and Kč 1,000 for each craft entry. The applicant (not his employees) must show proof of education, professional skill examination and period of practice, to meet the requirements for each given activity. The processing of applications lasts 1 to 4 months, subject to difficulties of re-negotiation. There is no guarantee that the registration will be successful within this period, even though the candidate has all the required skills. A bribe proportional to the expected producer surplus can significantly shorten both the time and the uncertainty. A similar story is told with regard to the problems of registering the limited liability companies.

TABLE V  
Size structure of manufacturing enterprises: A comparison between the Czech Republic and Austria

| Size (no. employees) | Czech Republic     |        | Austria            |        |
|----------------------|--------------------|--------|--------------------|--------|
|                      | No. of Enterprises | %      | No. of Enterprises | %      |
| 1–5                  | 23,927             | 63.75  | 24,906             | 56.59  |
| 6–10                 | 4,119              | 10.97  | 8,157              | 18.53  |
| 11–24                | 4,482              | 11.94  | 5,091              | 11.57  |
| 25–49                | 1,670              | 4.45   | 3,283              | 7.64   |
| 50–99                | 1,129              | 3.01   | 1,207              | 2.74   |
| 100–199              | 840                | 2.24   | 740                | 1.68   |
| 200–499              | 787                | 2.10   | 451                | 1.02   |
| 500–999              | 305                | 0.81   | 114                | 0.26   |
| 1,000 +              | 273                | 0.73   | 63                 | 0.14   |
| Total                | 37,532             | 100.00 | 44,012             | 100.00 |

Source: Authors' calculations based on the enterprise data from the Czech Statistical Office 1994 and Austrian Statistical Yearbook 1993.

### B. Availability of capital

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

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

Thus, in their search for capital, the majority of future Czech entrepreneurs had to rely on the financial market, primarily on the availability of bank credits. This situation is significantly different from that in developed market economies where the retained profits and depreciation provide 55–75% of total investment resources. After 3 years of unparalleled boost, in 1993 the Czech banking sector reached a considerable size, density and scope of activities. Nevertheless, its efficiency was still low and its functioning was subject to market imperfections. It is the bribe which blurs the distinction between a loan for a serious investment project and a non-performing loan purpose-

fully acquired for capital stripping and a subsequent suicidal bankruptcy. Even though the latter type of non-performing credits have been on the decrease since 1993 (there were estimates that they formed up to 30% of loans in 1991–92 and the estimates for 1993 are 10–15%), their role in spoiling the financial market ethics is substantial.

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

### C. Acquiring the business premises

Once the entrepreneur has succeeded in securing the financial resources, the next stage would be acquiring the business premises, a process also subject to official approval. But before applying for it, the future entrepreneur must be sure he has contracted some premises to be at his disposal. He may be saved a lot of problems if he receives some real estate as restitution or if he intends to run the business from his house or flat. Otherwise he must enter the real estates market and lease (very often just for 1 year only) or purchase the property. The private property market very quickly became quite competitive and efficient. The problem is, however, that its prices correspond to the housing shortage and the rent in some towns can reach \$50–700 per square meter per year. The payment must often be disbursed before the premises are approved by the district council.

Acquiring the premises in an auction is a special case, subject to the small privatization scheme. Their prices could be much lower than the competitive prices, especially if the information is incomplete or if the auction is rigged. That means that the success of the future entrepreneur depends on his capacity to comply with the illicit dealings. E.g. he is forced to get involved in the

'protection' ring and pay for fending off his competitors. But most probably he finds himself on the other side as a target of racketeering and extortion in order to abstain from the auction. Other privatization schemes available are the public tenders (e.g. submitting a 'competing project' for privatization) or the bids for a 'direct sale' (i.e. an exclusive right to purchase a property for an administratively stipulated price). The decision made by a privatization commission is often subject to most unexpected hazards: luck, bureaucracy, insider trading, corruption, etc.

The green-field capital investments appeared to be even more dramatic. The privatization of an already established and equipped company is a much simpler operation, both in the transaction cost and the capital requirements. However, in the long run it may not represent the most efficient way of market adjustment, restructuring and the use of resources.

#### D. *Getting the approval for running the premises*

Approval is granted by the district council pertaining to the location of the premises. The application is submitted to the district council where the applicant is resident, and part of the procedure involves receiving approval from the Commission for the Environment. It is irrelevant that the premises in question are in the applicant's own house, or that the same operation was undertaken there, already approved for the activities of the previous owner (e.g. who just went bankrupt), or that the business by its very nature cannot be damaging to the environment. The whole process may take 3 to 6 months, with no assurance of a successful outcome. This may become critical for those who were already having to pay for the premises and who could run the business immediately.

It is often only a (substantial) bribe or an offer to share the property that can speed up the procedure. The exclusive administrative monopoly of the district council is the main source of their power. The complaints filed regarding their bureaucracy, intentional procrastination, unfounded objections or professional incompetence seldom meet with positive response and applicants generally avoid raising them for fear of the council's retribution. The council can refuse

approval, or it can later order financial audits, controls of hygiene and simply harass the entrepreneur on endless (often fictitious) charges.

#### E. *Hiring the working staff*

The trials and tribulations of the entrepreneurs are not over once the business can be opened. One of the most damaging legacies of the communist past is the devastation of the workers' morale. The continuing very low level of unemployment in the Czech Republic, sustained by the government's extremely cautious bankruptcy policy (Hlaváček and Tůma, 1993) and numerous schemes for resuscitating the indebted corporations, are not pressing for a change in the working discipline. The average unemployment rate of 3.5% in December 1993, for a country in intensive transition, equals practically full employment. The 64 bankruptcies executed by the end of 1993 (out of 1,448 proposals delivered to courts – as disclosed by the Ministry for Economy in March 1994) and the closing down of approximately 40 minor inefficient state companies in 1992 are not forming an environment pressing for changes in the odd communist-time working habits.

Even though Czech wages are still significantly lagging behind the poorest countries in Western Europe, overall productivity is often nearly proportionally lower. The problem is not so much that the workers expect a soft, regular 8 hour shift and do their shopping or telephoning in the working hours, or that they lack the education or skills. Like in any other environment of adverse selection, that was in fact confirmed by their low remuneration. More damaging is the lack of identification with their jobs and the work environment. They are not accustomed to cooperate professionally in an informal way and they refuse to take risks, initiative or personal responsibility in their work. This is, however, an essential element of the environment required by the new post-Fordian organization of business (Piore, 1991). Customer friendly behaviour, immediate response to demand and loyalty to the firm are considered alien and often judged as 'disgusting hypocrisy'. The wage rises by more than 40% (as introduced by some foreign companies and banks) would be prohibitively costly in the vast majority of local firms and would deplete their falling profits even further, especially after the introduc-

tion of social security insurance and the wage regulation. Profits in the Czech industry fell by 28% in 1992 (see Benáček, Woergoeter *et al.* (1994, p. 71)) and the total wage cost rise of 5% was the only cost item which increased in the industrial sector in 1992.

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

#### F. *Running the daily business routines*

The transition from a sellers' market to a buyers' market, in process especially during September 1990–June 1992 and for which the macro-economic changes orchestrated by the government were absolutely crucial, was the most significant condition for the quick consolidation of those private activities based on market competition. These activities developed differently from those in many state firms in that they did not rely on artificially contrived market failures (rent seeking) or bureaucratic redistributive concessions. However, a transition from a sellers' to the buyers' market was still not completed in 1993. Some commodities in demand are still missing from the market (these are often cheap domestic products which lay idle in the factory stocks) or it takes a lot of time to discover who provides them. The price differentials are sometimes irrationally wide, the quality of the same product fluctuates, the quality does not relate to the price, the customers get cheated or rudely treated, etc. (e.g. ECOMA, 1993).

On the other hand, some buyers exercise their power over suppliers by requiring a tacit personal commission for a contract or asking for payment to be made in cash without any invoice. These

behavioral patterns signal that the market prices may not be perfect and that the market clearing may be incomplete.

As the discipline of the suppliers significantly consolidated in 1992, much lower stocks were necessary to secure the regular flow of business. The problem of the credibility of inter-firm payment discipline still remained critical. Some firms refuse to accept anything but cash, even for large contracts. The processing of a bank transfer can take up to a month, thus some firms cannot honour their debts because of short-term liquidity problems. Legal action against payment defaults is not a credible threat because the whole state judiciary system is in a crisis.

The price which Eastern Europe must pay for its capitalist resurrection is an increased intensity of work, a rise in general uncertainty and the proliferation of economic crime. While the first two are natural and revitalizing necessary conditions of individual initiative without the state paternalism, the last one is a mere institutional failure. Some reasons for these difficulties are:

- A lack of functioning institutions representing the state or corporate owner and systematically inquiring into the causes of crime;
- the respective laws (e.g. financial, commercial, anti-trust) are new and complicated and have many loopholes. There is a shortage of civil servants with the necessary expertise who could remedy the situation, since nearly all of them already work on the side of the trespassers who can remunerate them much better;
- the police and the judiciary are under severe pressure to solve more pressing day-to-day problems and there is a shortage of qualified lawyers to carry out the investigation.

#### G. *Financial links with the state*

There are three positive idiosyncrasies characteristic of traditional Czech society: to be self-reliant, to abide by the fiscal obligations and to save. The systemic stimuli against these behavioural patterns, i.e. towards mafia-type of collusion, fiscal offence and forced uneconomic use of resources, are generally taken as frustrating, further infringing the rules of fair play.

It came as a surprise that the Budget revenues from the ill-prepared new VAT scheme of 1993 surpassed all expectations. This scheme, intro-

ducing a 5% tax on food and a 23% tax on the majority of remaining products, became a nightmare for small entrepreneurs. The law was very complicated, it was subject to constant amendments and badly advertised. The help offered to SMEs by the tax exemption option proved later to be a disadvantage, disorganizing the pricing procedures and creating the need to search for (very scarce) professional accountants.

The level of taxation in the Czech Republic is high even by some West European socialist standards. An income (profit) tax of 45% for physical persons and 42% for businesses, with practically no tax relief for the heavily investing or the newly established firms, is a mighty disincentive to run one's own business. Many small firms are tempted to manipulate the costs (e.g. on expensive furniture, electronics, cars or travels) in order to attain a 'fair' level of taxation (Charap, 1993). Another serious burden is the compulsory 49.5% social and health insurance levied from 1993 on the gross payrolls (36% of this is paid by the employer). In addition to the 13.5% insurance contribution by the employee, the personal income tax must also be paid, so that the individual's net income in its upper brackets is by 47% lower than the labour cost paid to him/her by the employer. E.g. the average gross wage in industry in December 1993 was Kč 6,923 per month, representing a 24% increase in one year. If the 36% insurance is added, the resulting labour payment amounts to Kč 9,415 (\$3,923 per year).

Tax evasion is a strong temptation for those small businesses that sell directly to consumers or foreign firms. The net 'profit' can be thus increased approximately 2–3 times and the risk of being prosecuted is negligible. The Ministry of Finance estimates the arrears in tax payments alone to be more than Kč 10 bil. in 1993 (including the corporate sector), while the SME support schemes comprised Kč 16 bil. (the vast majority was allocated to agriculture). The tax evasion has thus become one of the most important instruments for the capital accumulation for SMEs during the transition. Naturally, not everyone is capable of using this instrument, even though the quest for survival pressures many entrepreneurs to use the tax evasion as a last resort for keeping in competition with the less honest competitors. As a result, this unofficial (but

tolerated) 'scheme' for the promotion of small businesses punishes virtues and rewards vices, becoming one of the least efficient arrangements which could have been adopted.

According to the survey conducted among a panel of randomly chosen 256 manufacturing firms in March 1994 (Zemplerová *et al.*, 1994), in which 33 newly-established firms have been compared with 223 incumbent firms (these were former state-owned firms), the new start-ups have proved not only to have been more productive and growing faster by comparison with incumbent firms, but they also paid more attention to the quality of products and innovated more. The newly started firms were nearly exclusively small and medium sized firms. These findings, the summary of which is in Table VI, are consistent with the policy which is directed towards the support of new-start ups and SMEs.

TABLE VI  
Comparison of the growth of new start-up firms and old incumbent firms between 1991–1993

|   | New start-up | Incumbent firms |
|---|--------------|-----------------|
| Growth of sales <sup>a</sup>              | +22%         | -1%             |
| Growth of profit <sup>a</sup>             | +14%         | -64%            |
| Growth in the average number of employees | +23%         | -32%            |
| Inventories                               | -32%         | -24%            |
| Average salary                            | +34%         | +31%            |

<sup>a</sup> In current prices.

Source: See Zemplerová *et al.*, 1994.

### 3. Economic policy and its influence on the environment of small businesses

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

- \* A fiscal policy aimed at dismantling state paternalism towards enterprises by abolishing the plan and its subsidies, introducing a balanced budget and decreasing taxes;
- \* A prudential monetary policy checking the danger of inflation;
- \* Fixing the massively devalued exchange rate to



a role of nominal anchor and liberalizing the trade on current account transactions.

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

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

standards. See Table VII for an overview of the main macroeconomic indicators.

However, the whole process had some snags which became apparent only after deeper scrutiny of the microeconomic developments. (For a more extensive discussion of the industrial policy issues see Landesmann (1993) and Aiginger (1993)) First, the government assumed that functioning markets would develop on their own, once the macroeconomic conditions were favourable, and it would not be essential to continue in the SME support schemes introduced in 1990. Later on, some general and many discretionary concessions were made, even though the rhetoric of 'no industrial policy' was still maintained. Let us now discuss some of the more visible aspects of the

TABLE VII  
Selected official indicators for the Czech Republic (1994)

| Indicator                                      | 1989   | 1990   | 1991  | 1992   | 1993   | 1994    |
|--|--------|--------|-------|--------|--------|---------|
| Nominal GDP <sup>a</sup>                       | 524.5  | 567.3  | 716.6 | 803.3  | 923.1  | 1,037.5 |
| Real GDP <sup>b</sup> % change                 | 4.5    | -1.2   | -14.2 | -6.6   | -0.3   | +2.6    |
| Real industrial production <sup>b</sup> %      |        | -3.5   | -22.3 | -10.6  | -5.3   | +2.3    |
| Productivity of labour %                       | 2.2    | -0.3   | -9.2  | -4.1   | -1.2   | +5.2    |
| Producer Price annual inflation %              | 1.2    | 16.6   | 54.8  | 9.9    | 13.1   | 5.5     |
| Consumer Price annual inflation %              | 1.9    | 10.0   | 57.9  | 11.1   | 20.8   | 10.0    |
| Real personal income <sup>b</sup> % change     | 2.2    | -0.2   | -27.1 | 5.9    | 5.6    | 8.5     |
| Private consumption <sup>b</sup> % change      | 2.8    | 2.9    | -24.0 | 15.1   | 2.9    | 5.3     |
| Public Consumption <sup>b</sup> % change       | +7.6   | -0.8   | -9.1  | -3.1   | -0.1   | -2.3    |
| Fixed capital invest. <sup>b</sup> % change    | +3.2   | -2.1   | -17.7 | +6.3   | +4.2   | +3.4    |
| Change in inventories <sup>b</sup> % p.a.      | 3.8    | 12.1   | 2.9   | -24.3  | -24.4  | n.a.    |
| Rate of unemployment %                         | 0.0    | 0.8    | 4.1   | 2.6    | 3.5    | 3.2     |
| Inter-enterprise indebtedness <sup>a</sup>     | n.a.   | 39.3   | 113.2 | 94.4   | 150    | 132     |
| Exchange Rate (Kč/\$), average                 | 15.1   | 18.3   | 29.5  | 28.3   | 29.2   | 28.8    |
| Budget deficit or surplus <sup>a</sup>         | -3.5   | +4.2   | -12.0 | -16.7  | +1.1   | +10.4   |
| Share of OECD in exports %                     | 31.2   | 42.7   | 55.2  | 67.5   | 69.9   | 71.2    |
| Exports (visibles) <sup>c</sup>                | 10,942 | 9,203  | 7,985 | 8,842  | 10,163 | 11,730  |
| Imports (visibles) <sup>c</sup>                | 10,720 | 9,562  | 7,145 | 10,273 | 10,772 | 12,581  |
| Current account balance <sup>c</sup>           | 400    | -1,105 | 356   | -305   | 433    | 298     |
| Balance of payments <sup>c</sup> (surplus = +) | +590   | -1,102 | +898  | -80    | +3,029 | +2,372  |
| Net foreign investment <sup>c</sup>            | 171    | 120    | 511   | 947    | 1,540  | 842     |
| External Debt <sup>c</sup>                     | 7,900  | 8,100  | 9,400 | 9,600  | 9,605  | 11,943  |
| M2 <sup>a</sup> , % change                     | 4.4    | 3.7    | 27.3  | 25.4   | 20.5   | 21.5    |
| M1 <sup>a</sup> , % change                     |        | -10.0  | +26.7 | +15.0  | +14.6  | +18.1   |
| Average lending rate to firms %                | 5.0    | 6.1    | 15.4  | 13.8   | 14.1   | 13.2    |
| Number of Banks                                | 4      | 9      | 28    | 46     | 56     | 59      |
| Loans <sup>a</sup> , % change                  | -2.0   | -7.7   | +14.5 | +13.7  | +19.9  | +14.3   |
| All Foreign Exchange Reserves <sup>c</sup>     | -      | 1,200  | 3,300 | 3,600  | 6,245  | 8,894   |

<sup>a</sup> Kč 1 billion, nominal.

<sup>b</sup> Kč billion, 1984 prices.

<sup>c</sup> US Dollars million.

Sources: Statistics of SBČS (1990-92), CNB (1993-94), PlanEcon (1994).

current economic policy of the government and their relationship to the local entrepreneurship.

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

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

c) *Market efficiency.* The experience of all developed market economies shows that it would be a doubtful policy to assume that the best role for the government in creating the competitive markets, ownership structures and entrepreneurship is to abstain completely from any involvement. The initial set up of the post-socialist markets and ownership is confronted with too many non-economic interferences, imperfections, failures and insufficient provisions for the public goods (Benáček, 1993). The paradox here is that hardly any government and its bureaucracy can be entrusted to be a direct effective provider of market efficiency.

d) *Stock market.* It took three years and a lot of government support to prepare conditions for a functioning market with commercial paper. Two competing stock exchanges, opened in June 1993, and hundreds of stock brokers, have shown the ability to provide competent services for the local 7 million stockholders. After very shy trading and falling stock prices during the previous three months, the market recovered from a price index of less than 500 points in October 1993 to 1,045 in January 1994. The turnover on the Prague Stock Exchange alone in its first year reached Kč 54 billion, with 1,007 different emissions traded. However, the transfers of equity outside the stock exchanges are estimated up to Kč 500 billion (Hospodářské noviny, 5.5.94). In 1993 the foreign portfolio investment (\$1,060 million) and the foreign loans to firms (\$500 million) became a more important resource of capital than the total of FDI's (\$550 million). The majority of stock trading abroad was channelled through the stock market in Vienna. Its turnover of the Czech and Slovak commercial paper in 1993 was approximately three times higher than what was recorded in the Prague Stock Exchange. The catastrophic expectations of some experts that the voucher stockholders would immediately swap their equity for whatever cash it may bear, and thus bring a collapse of the market, were erroneous.

e) *Money market.* In all transient economies banking and financial services remain one of the main bottlenecks of growth (Phelps *et al.*, 1993). This paralytic infection is deeply seated in the central institution of the emerging capitalism – the flow of money – attacking primarily the capital market. The government, being always aware of the key role of money in emerging markets, took many measures to avoid risks. However, the tasks seem to be much harder to accomplish than anyone expected. The country is constantly fighting the global capital shortage, even though not all firms are under a taut capital constraint. The average real interest rates continued to be negative in 1993. (e.g. the real yield on deposits and bonds for July 1992–September 1993 vary between zero and – 12%.) The interest tax of 15% on deposit and 25% on commercial paper yields lowers even further the incentives to save. Private business access to bank credits remains extremely difficult, a situation that is often solved by forced

inter-firm credits (i.e. by defaults in payments). However, one scheme has been undertaken by the government, notably the creation the Czech-Moravian Guarantee and Development Bank.

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

g) *Labour market.* The average unemployment rate not exceeding 3.5% since January 1992, with the average unemployment duration of 4.3 months in 1993, means practically full employment. The extensive employment restructuring was proceeding inconspicuously, yet quite intensively. The frictional and structural unemployment caused by this process was solved locally in the majority of cases. However, even in the worst hit regions of Moravia, with the unemployment rates above 5%, the wages have still been inflationary. It seems obvious that the natural rate of unemployment in the economies in transition should not be lower than in the developed market economies. Therefore, even the average unemployment rate of 5%, predicted for the Czech economy for 1995, must be considered below the natural level. The low level of unemployment throughout the Czech Lands was mainly due to the following factors:

- low wages and thus a low share of labour costs on total costs,
- inefficient labour market and the resultant tendency of firms for labour hoarding,
- political sensitivity of managers to the unemployment policy,
- state corporate debt relief schemes,
- reluctance of banks to bring their corporate creditors to bankruptcy,
- efficient employment schemes (e.g. a subsidy of up to Kč 50,000 for companies hiring an unemployed person in certain districts), where practically a third of the labour force experienced unemployment during 1990–94,
- development of the generic private sector, especially the small and medium-sized firms.

The private sector was thus able to absorb quite quickly and smoothly the departures and the lay-offs from the corporate (mainly manufacturing) sector in 1990–93. At least 1.7 million jobs were created in the booming SMEs during the first 4 years of transition. With the officially recorded labour mobility over 1.5 million workers only in 1990–92 (MPSV, 1993), out of the initial full employment of 5.3 million in 1989, the real mobility (including the transfers inside the corporate sector) for 1990–94 could affect 50–60% of the labour force.

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

The tendency for labour hoarding, which is especially typical for the large former state companies, can be also judged as a tendency for hidden unemployment. Once the competition on the commodity markets becomes fierce, which may happen after continued appreciation of the Czech currency, accompanied with further rises in real wages, the hidden unemployment may become a sharply rising open unemployment. As the build-up of the SMEs is completed, it will be impossible to rely on them to hire the bulk of unemployed.

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

i) *Privatization.* The privatization schemes,

along with the availability of financial capital, are crucial conditions for the free rise of entrepreneurship. The privatization was marked by class orientation, as it was divided into so called 'small' and 'large' privatization schemes. The large scale scheme could be divided into the voucher scheme, auctioning at tender bidding, direct sales to pre-determined buyers, restitutions and free transfers. Establishing Investment Privatization Funds (IPFs) was a scheme closely linked with the voucher scheme, which enabled the collection of a large portfolio of stocks (equity) and an active participation in the managements of privatized joint stock companies. The extent of the privatization opened an enormous potential for the rise of entrepreneurship, ownership and management.

The total value of assets privatized was Kč 750 billion, which compares well with the total value of assets of Kč 900 billion in the industrial sector or Kč 1,600 billion in the whole production sector (evaluated at book value prices in 1990). Approximately 1.5 million employees thus became employed in the Czech private sector. The booming new small businesses offered nearly as many new jobs and competed for employment with the big companies. Practically all massive lay-offs from the former big state corporations were absorbed by them.

As can be seen, the recent Czech economic policy instruments had numerous impacts on the business sector, some of these quite delicately chosen both in time and sequence, some seemingly random, and some void of any pre-conceived positive aim. As far as the promotion of entrepreneurship in small businesses is concerned, we can hardly speak about the existence of an extensive systematic policy. Even though it is generally agreed that the government should be involved in such policies, it still remains uncertain whether the government has at its disposal reliable and efficient instruments for full-fledged control of this task. Until recently very few economic textbooks were concerned with this question. In the best cases, it was tacitly understood that entry into business and the accumulation of capital required simply time and patience. In the worst cases, it was said that the only way to get started was by parsimony, patrimony and matrimony. Undoubtedly, we cannot expect a miraculous change to come about in this area.

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

### **5. Assistance to small and medium enterprises**

There is a consensus within governmental bodies that small and medium enterprises deserve assistance during the transitional period in order to multiply their positive roles in the economy and in society as a whole.

Less consensus exists on how to implement the policy towards small businesses, i.e., which institutions and instruments of the SME assistance to employ in order to meet the objectives of an economic policy towards SMEs.

The experience of programs to assist small and medium enterprises show the tendency to apply global solutions rather than looking at the concrete problems of the businesses in the country (Roman, 1991). Administration can absorb a large share of the available means. Less successful enterprises can be subsidized to the detriment of more successful ones. Programs are often lacking flexibility to adjust to the concrete needs of SMEs. The implementation of such programs has created certain frustration (Webster, 1991).

After a big boom in the Czech SMEs sector during the first two years, a slow-down in the sector of SMEs development occurred. The development of SMEs sector coincides with the policy towards SMEs. Government policy, legislation, and bank policy were relatively favourable for SME development after the revolution in 1989. Existing barriers to entry have gradually been removed, the approval process become less bureaucratic, and the state provided tax advantages for small businesses with less than 25 people.

It was not difficult to obtain credit during the second half of 1990, 1991, and in the first half of 1992. A relatively liberal credit policy was due to the fact that the Central Bank provided large

amounts for re-finance credits, and the existing state banks did not consider the risk of providing credits to SMEs. The banks did not require collateral other than assets on which the credit was provided, and did not ask for a credit history; required business plans were simple and often elaborated by bank officials. In addition, the state did not have a strong and sophisticated internal revenue service.

SMEs sector grew through new start-ups, restitutions, small scale privatization, and the division of big state enterprises into smaller units. The monopolistic structure also provided niches for SME activities. There were empty industries with great potential of growth in the economy.

New start-ups became attractive by virtue of a better than 'average' conditions (salary regulation in the state sector allowed for the transfer of labour to private enterprises).

These sources of the SMEs sector growth have been exhausted and in addition to it new tax laws have been enforced since January 1993. These new laws have given a signal that there should not be any special support of SMEs. The liberal government wants to avoid any discrimination against or any support for a specific branch or group of enterprises. However, such an approach could be applied, in our opinion, only in a stable, balanced economy, which has standard structure. That is not the case of the Czech economy. Big enterprises are being helped by the National Property Fund and the Consolidation Bank. The Czech economy still awaits for deep restructuring. That is why the supporting policy towards SMEs is justified and reasonable.

The present situation does not signal further growth of the SMEs sector, on the contrary numerous bankruptcies can be expected. The future situation of SMEs will be influenced by several major factors:

- Effective January 1, 1993 a new tax system based on the introduction of value-added tax, new taxation system in social security, and health care was implemented. New tax laws imposed a bigger tax burden on SMEs than during the previous period.
- Advantages for businesses smaller than 25 employees have been removed.
- Many of SMEs (especially all MBOs) have

both privatization credits as well as investment credits. Debts incurred by investments, together with debts due to privatization, are high, and companies have to achieve rentability of at least 30–50% to be able to repay the loans. Some SMEs will be not able to reach such profits and will default.

- The present availability of credit and venture capital is low. Given the prudent policies of the banks, SMEs are unable to obtain the credit they desire, particularly because of inadequate collateral or missing credit history.
- Inter-enterprise indebtedness concerns more often smaller, weaker businesses than large enterprises, which will be most probably bailed out by the state. The threat of a chain of bankruptcies will develop; pressure on state budget and banks resources for restructuring will exhaust most of the available credits.
- Salary controls also concern private businesses. (The average salary in businesses with less than 25 employees decreased by 8.8% in June 1993, whereas in the enterprises with more than 25 employees it increased by 4.8% in June 1993 – *Hospodarske noviny*, 13 Aug, 1993).
- An increase in competition among domestic producers as well as from importers will also lead to the bankruptcies of smaller, weaker units. One can expect that imports will threaten the low-tech, small domestic firms producing undifferentiated consumer goods.

This is why supporting schemes for SMEs have become even more important than before. Several schemes of SME (small and medium enterprises) support have been adopted in the Czech Republic during 1990–1993. A certain specialization can be traced in the case of particular programmes. The Czech American Enterprise Fund seems to specialize in venture capital. The Japanese program focuses on export support. PHARE program for SME support has rather a diversified structure, but its main activity is to provide small loans and credit guarantees.

There are national programs administered by the Ministry of the Economy, financed from the state budget and from the National Property Fund. There is sectoral assistance, for example, for agricultural products provided by the Ministry of Agriculture. There are numerous local activities

for SME support financed by local governments and other sources.

In order to use support efficiently, a general environment for entrepreneurship should be created. In order to meet this goal, sound commercial banks and competition between banks should be created. At present, banks still have little experience and incentive to select viable private projects.

SMEs are a natural and an omnipresent segment of any market economy. A prevailed consensus in the economic literature in the 50s and 60s claiming that small enterprises are an anachronism condemned to extinction and that only big concentrated enterprises can be effective. Government policies at that time were directed to support large scale business to the detriment of small businesses. In spite of this, from the early 70s until more recent times, small businesses have flourished in many industries in all developed countries, while CPEs with their large enterprises lacking small and medium business completely collapsed. Today, about one quarter of the total labour force works in small businesses with less than 25 employees. Small businesses thus represent an important segment of the economy as well of the whole society. As developments during 1992–1993 demonstrated, SMEs are very sensitive to government policy, and changes in policy toward SMEs can lead to the deterioration of the performance of the economy as well as to political re-shuffling within the government.

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