

**THE ENTERPRISE SECTOR
DEVELOPMENT IN THE
CZECH REPUBLIC:
LARGE ENTERPRISES
AND SME PERSPECTIVE**

Lubomír LÍZAL

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Lubomír Lízal

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Abstract

This paper briefly describes the historical development of Czech enterprises sector from the establishment of Czechoslovakia over the war period and communism while focusing on the changes during the reform (transition) process. It deals both with the medium and large size companies as well as the entrepreneurial sector as well. A special interest is paid to the legal framework and its effect on conducting business. Lastly, it also gives a brief overview of the bankruptcy procedures; this section is a natural complement to the main part that, in essence, describes establishment, entry and changes of new firms or former state-owned enterprises.

Historical Background

Although we can trace history of certain Czech enterprises back to the times of Austro-Hungarian Empire, current situation in the Czech Republic depend much more on the development after the World War II during the communist regime. Yet, from the general perspective, Czech lands were the most industrialized part of the Austro-Hungarian Empire and, shortly after the establishment of independent Czechoslovakia in 1918, were among the 10 major industrialized countries. During the period of twenties and thirties of the past century, the Czechoslovak enterprises benefited from the strong tradition of craftsmanship and skilled labor force (e.g., Bohata and Mladek, 1999).

Although there was a noticeable governmental effort to help regional industrial development in these times, the regional imbalances prevailed even up to-date. In general, the intensity of industrial level of pre-war Czechoslovakia decreased from west to east significantly. From the regional perspective and using the historical measures, we can say that the western part (Bohemia, Moravia and Silesia) was highly industrialized, while east part (Slovakia and especially Rutheina,¹ which is today a part of Ukraine) was a typical rural economy.

As can be clearly seen from Table 1, although large firms with more than 500 employees represented only 1.1% of the medium and large firms, they contributed almost 30% to the industrial employment. Firms with more that 100 employees employed more than half of the total industrial labor force, although they represented only 7% of the population. This can be interpreted as a clear signal of industrial concentration.

Table 1 – Structure of Employment and Firms in the Manufacturing Sector, 1930

Size Category	Firms		Employees	
	Share %	Number	Share %	Number
6-20	69.0	28 612	15.6	262 326
21-50	17.0	7 020	13.3	223 538
51-100	7.0	2 905	12.3	202 617
101-250	4.4	1 833	16.8	281 144
251-500	1.5	622	12.7	213 667
More than 500	1.1	443	29.4	492 160
Total	100	41 438	100	1 657 272

Source: Teichova (1988)

Note: Only firms with more than 5 employees are included.

The effect of communist took-over in 1948 is documented in Tables 2 and 3. Within one decade, the private share on national income dropped from approximately one third to less than 7%. As the time passed, the private sector was almost eliminated. All estimates of private contribution to GDP in the eighties are well below 3%. The trend is also well-documented on the employment, in 1948 there were more than 2 millions private farmers, yet several decades late all private farmers and self-employed people accounted to mere 24 thousands in the whole Czechoslovakia (population was over 15 million in the eighties and over 12 millions in 1950).

Similar pattern to the one observed in whole Czechoslovakia existed in Czech lands (Bohemia and Moravia), however there was more pronounced oppression of the private sector as there Czech lands were more industrialized and the share of primary agriculture production on GDP was even lower.

¹ *Zakarpatská Ukrajina* was the name of the region in Czech.

Table 2 – Shares on National Income (GDP Proxy)

Sector	Year	1948	1960	1970	1980
State (Public)		62.9	81.8	85.1	87.5
Cooperative		2.6	11.6	10.5	9.9
Private		34.5	6.6	4.4	2.6

Source: CSO (1985), p.55-56.

Note: Current prices used.

Table 3 – Employment Shares, in thousands of employees, whole Czechoslovakia

Sector	Year	1948	1953	1960	1970	1980
State (Public)			4022	4797	5854	6544
Cooperative			407	855	851	803
Private/self	2176*		1307	262	158	24
Total	5497		5736	6039	6864	7370

Note: * Includes only farmers.

Source: CSO (1985), p.55-56.

Table 4 – Employment Shares, in thousands of employees, Czech lands

Sector	Year	1948	1953	1960	1970	1980
State (Public)			3094	3714	4282	4582
Cooperative			277	691	572	501
Private/self	1289*		791	82	48	13
Total	3984		4163	4487	4901	5097

Note: * Includes only farmers.

Source: CSO (1985), p.424.

The following Table 5 shows the opposite process, started in the fall of 1989 after the fall of communism in the region. In a remarkably short period of two years almost one million of self-entrepreneurs emerged. However, substantial portion of self-employers still kept regular jobs and undertook the entrepreneurial activity as a part-time job. When we compare these numbers with registered legal entities, we get more appropriate figures about the enterprise sector. Table 6a shows, that the most numerous legal type of (incorporated) enterprise is the limited liability company. Indeed, this form of enterprise requires small amount of capital to set up (slightly over EUR 3000) and the bureaucratic burden to run the company also much smaller compared to joint stock company.

Table 5 – Number of Businesses, by selected legal form, as of Dec 31 of each year

Year	Total	Out of which (selected legal form)		
		State-owned Enterp.	Joint-Stock	Self-Entrepreneurs
1990	178 993	3 505	658	124 455
1991	955 647	3 737	2 541	891 872
1992	1 118 637	3 272	4 076	982 075
1993	1 250 216	2 920	4 813	1 044 635
1994	1 118 534	1 522	6 017	856 509
1995	1 321 096	2 270	7 564	1 000 375
1996	1 468 940	1 886	9 255	1 103 732
1997	1 627 626	1 621	10 353	1 223 195
1998	1 781 334	1 312	11 697	1 327 891
1999	1 963 319	1 214	13 009	1 425 743
2000	2 050 770	1 117	14 092	1 471 291
2001	2 121 562	1 054	14 845	1 523 051

Source: CSO (2002), p.361.

Only about 55% of the court-registered companies belong to the enterprise sector (second line of Table 6a) and this fraction is quite stable after the turbulent first half of nineties of the past century. Also major private corporate legal forms (joint stock companies, limited liability companies and cooperatives) keep the same shares in the total numbers of registered entities despite its doubling absolute numbers from 1995. As the absolute number of state-owned companies decrease, their relative share drops even faster. The changed pattern for foundations is caused by a major change of legal requirements in year 2002; the absolute number of registered foundations dropped by one third. Some of these foundations emerged as non-profit entities (see Table 6b).

A most remarkable feature is the rising involvement of foreign owners (this is in line with the FDI trends discussed later), in 1995 foreigners owned about one sixth of all registered businesses while in 2001 they controlled one-third of these. Given the rising absolute number of enterprises in the period, the absolute number approximately quadrupled.

Table 6a – Court-Registered Legal Entities (Enterprises), by legal form, % of total.

	1995	1999	2001
Total Registered Legal Entities (absolute number)	100.0 (196 434)	100.0 (343 357)	100.0 (389 480)
Businesses and Companies:	57.3	54.8	55.1
General Commercial Partnership (v.o.s.)	3.0	2.1	2.0
Limited Liability (s.r.o.)	50.2	48.7	49.2
Joint-stock (a.s.)	3.9	3.8	3.8
State-owned Enterprises	1.2	0.4	0.3
Cooperatives	3.1	3.0	3.0
Foundations	2.2	1.2	0.9
Governmental (Budgetary) Organizations	0.6	0.3	0.1
Semi-Budgetary Organizations	1.5	0.9	1.1
Schools, Health Establishments	2.7	1.5	1.1
Associations of Legal or Natural Persons	22.1	22.0	21.9
Other	9.2	16.1	16.5

Source: CSO (2002), pp.368-369.

Table 6b – Registered Businesses (Enterprises), by institutional sector, % of total.

	1995	1999	2001
Total Registered Businesses	1 321 096	1 963 319	2 121 562
Public Businesses and Corporations	3 811	3 197	2 651
Private Businesses and Corporations	143 723	259 990	290 320
Foreign-owned	26 777	81 547	99 762
Government	15 587	14 734	15 321
Private Non-profit	47 863	79 053	101 257
Households	1 109 945	1 606 155	1 711 816

Source: CSO (2002), pp.368-369.

Table 7a shows, how quickly the private contribution to GDP was achieved in various CEECs, while Table 7b shows the differences between Czech and Slovak Republics at the time of their separation. These figures provide an illustrative background to the enterprise sector development and document the enormous speed of shift of production from state sector into the private one.

Table 7a – Shares on GDP, International Comparison

	1990	1994	1995	1996	1997	1998	1999	2000
Czech Republic	5	65	70	75	75	75	80	80
Croatia	10	40	45	50	55	55	60	60
Hungary	20	55	60	70	75	80	80	80
Poland	25	55	60	60	65	65	65	70
Slovak Republic	5	55	60	70	75	75	75	75
Slovenia	10	30	45	45	50	55	55	55

Source: EBRD (2001).

Table 7b – Shares on Industrial Production, firms with more than 25 employees, 1992

Ownership	Czech	Slovak
Private	13.2	2.1
State	79.7	94.3
Foreign owned	4.0	1.5
Cooperatives	1.5	1.6
Other	1.6	0.5

Source: Courbis and Welfe (1999), p. 36.

On the Eve of Privatization

As the Central and East European (CEE) countries embarked on the transition from a planned to a market economy in the early 1990s, apart yet uncertain means of privatization, the restructuring of state owned enterprises (SOEs) became a major policy issue. From the standpoint of altering the size and number of firms and bringing in new management, one of the most important forms of restructuring observed during the CEE transition was the massive breakup of SOEs in Czechoslovakia and to a lesser extent in Hungary in the early 1990s. Similar phenomenon occurred later in (post-)Yugoslavian countries (e.g., Domadenik et al, 2003). In Czechoslovakia, many divisions (subsidiaries) of SOEs applied to their supervisory ministries for permission to break away from their “master enterprise” in the 1990-91 period. The ensuing process of negotiations among government officials, top managers of the SOEs and divisional managers resulted in a phenomenal wave of spin-offs, giving rise to a large number of “new” firms led by new top management. These firms later entered the privatization process, although at the time of the spin-offs the means and extent of privatization was yet unclear. In particular, while Czechoslovakia started in 1990 with about 700 industrial enterprises employing more than 25 workers, by mid 1992 the number of industrial firms in this category had virtually tripled to about 2000.

This restructuring preceded other major reforms (e.g., privatization discussed later), as prices were still under state control in 1990 Czechoslovakia, and even in 1991, when prices were by and large free, the state still owned the firms. Moreover, the Czechoslovak authorities eliminated quantitative import restrictions as early as 1990, and the average level of trade weighted tariffs became as low as 5% (Drabek and Smith, 1995). However, in 1990-91 the firms in Czechoslovakia were temporarily protected by a uniform 20% import surcharge tax (Dyba and Svejnar, 1995). Also trade with Western economies experienced a phenomenal boom and by mid-1990 exceeded the value of trade with the former Soviet bloc countries.

First 10 Years and Privatization

After the fall of communist regime the former Czechoslovakia had one of the smallest private sectors in the communist world, as documented earlier. The Czech privatization program was often cited as one of the major success stories of the transition in Eastern Europe. In remarkably short period, the mass privatization program resulted in almost 75% of

productive capacity being transferred to the private sector (see Table 7a) within the span of years 1992-1995.

Table 8 – Registered Corporations According to Ownership

Type of Company	1991	1992	1993	1994	1995
Number of Incorp. Individuals	891,872	982,075	1044,635	856,509	1000,375
Total Number of Corporations	57,083	83,965	116,706	153,937	196,434
Privately Owned	16,913	30,097	47,446	64,343	88,582
Cooperatives	4,031	4,148	4,638	5,227	6,172
State Owned	16,762	14,125	11,113	9,733	9,432
Municipality Owned	876	5,490	8,099	9,199	9,980
Foreign or Joint Ventures	6,349	8,780	13,970	22,715	33,687

Source: Kocenda and Lizal (2003), chapter 8.

Three programs were the core of the privatization in the Czech Republic: restitution, small-scale privatization and large-scale (or mass) privatization. The latter one is often erroneously considered to be the same as voucher privatization scheme but in essence, as we document later, voucher scheme was just a significant component of the mass privatization. The whole process of privatization resulted in a remarkably fast shift of production from the state to private sector. Unfortunately, the split of the former Czechoslovakia on January 1st, 1993, affected the privatization. Originally, the privatization was carried out jointly in the Czech and Slovak Republics but as the data is now available for each republic separately it makes our analysis of Czech enterprise sector development easier.²

Property restitutions and small-scale privatization two started in 1990 and were most important during the early years of transition. Also, they significantly contributed to the emergence of SMEs, unlike the mass privatization later. Restitution restored assets to those from whom they had been nationalized by the communist regime after 1948 and as implementation was carried out by direct negotiation between current and former owners (Kocenda and Lizal, 2003, report 200000 claims for agricultural land, 70000 apartment buildings returns to former owners). Former owners of enterprises were entitled to receive their shares during its privatization against their restitution claims. Small-scale privatization targeted small units such as shops and restaurants that were sold at public auctions to Czech citizens or corporations, any future transfers of the auctioned unites to foreigners were banned. By the end of 1993 the program was finished.

Large-scale privatization was the most important privatization program in the Czech Republic. Enterprises that were not privatized through restitution or small-scale privatization and were not targeted for liquidation went into this scheme. Ministry of Privatization was established to conduct the process; it was later replaced with the National Property Fund (NPF). The fund was also entitled to hold shares and execute or delegate ownership rights.

Large-scale privatization comprised several privatization techniques. Smaller enterprises used to be auctioned or sold in tender; medium-size firms were sold in tender or to a predetermined buyer in direct sales. The largest corporations were transformed into joint stock companies and their shares were distributed either during the voucher privatization, or sold for cash or transferred for free. Combination of all approaches was also possible and quite common. The result of large-scale privatization is documented in the Tables 9 and 10.

For each firm assigned to the mass privatization, the firm's management had to submit a privatization plan depicting for how the firm could be privatized. This proposal could involve any combination of all available methods of privatization (e.g., voucher scheme,

² Aspects of privatization are described, for example in Frydman, et al. (1994) or Kotrba (1995).

domestic direct sale, foreign direct sale, public auction or tender, free transfer, or employees' shares). It was possible for anyone other than the firm management to submit a competing privatization plan for all or part of each enterprise. On average 4.72 projects per firm were submitted.³ The supervising ministry and the Ministry of Privatization decided on the winning project (foreign sales had to be approved by the government) while, as turned out, managerial proposals were most likely to be approved. In addition, privatization authorities wanted to meet their goals on the amount of property to be allocated for the voucher program. This process was conducted in two ways, the first wave was common for both Czech and Slovak Republics (as it started prior January 1st, 1993) while the second wave took place only in the Czech Republic.

Table 9 – Mass Privatization through Shares of the National Property Fund (as of Dec. 1996)

	Mil. CZK	%
1. FNM holdings total	7137000	100.00
From Privatization projects	694094	97.25
NPF investments via bonds	13171	1.85
Other	4422	0.62
2. Privatization of shares		
For sale	68505	9.60
Public offer	12605	1.77
Direct domestic sale	22207	3.11
Direct foreign sale	13713	1.92
Employees' shares	2204	0.31
Public tender	17776	2.49
Free transfers	431802	60.50
Voucher privatization	341436	47.84
Municipalities, funds	52331	7.33
Restitution Investment Fund	19672	2.76
Endowment Investment Fund	515	0.07
Restitutions	1756	0.25
Guarantee Relief Fund for Agriculture	16092	2.25
Registered capital reduction	-3641	-0.51
RIF shares	6148	0.86
3. Shares held by NPF	208873	29.27
Strategic companies	170060	23.83
Other companies	38813	5.44
4. Shares not booked	2013	0.28

Source: CSO (1997), p. 513.

Table 10 – Voucher Privatization

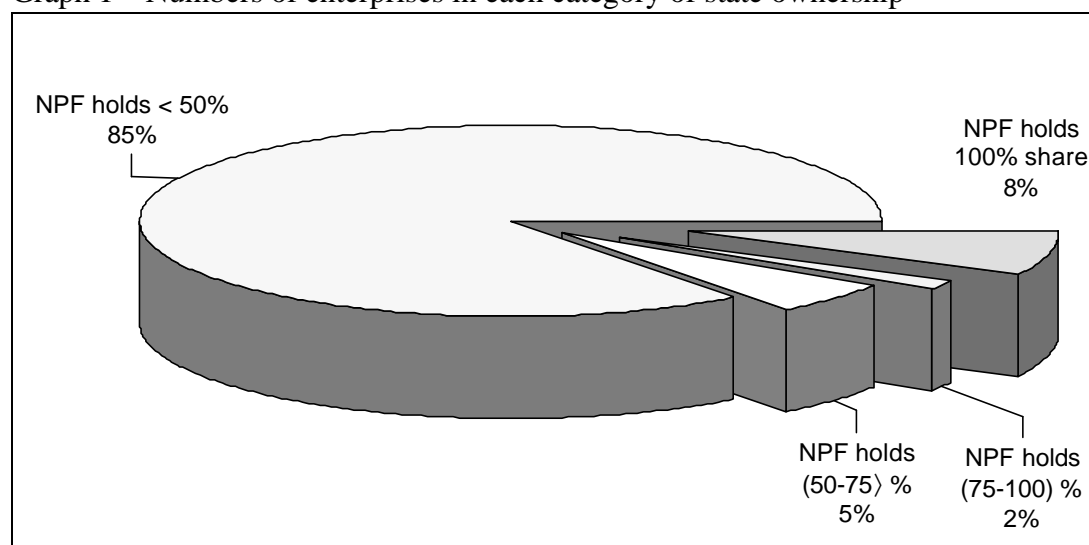
	Wave 1	Wave 2
No. of State Enterprises Entering the Voucher Scheme	988	861
Book Value of Shares Allocated for Voucher in Particular Wave (bln. CZK)	212.5	155.0
Participating Citizens (mln.)	5.98	6.16
Average Accounting Value of Assets per Participating Citizen (CZK)	35,535	25,160

Source: Ministry of Finance, Ministry of Privatization

³ This is for the first wave of voucher scheme. For more details see Kotrba (1995), selection of firms and timing is analyzed for example by Gupta et al. (2000).

Although the scale of the mass privatization is impressive and substantial portion of the state stakes was privatized, there still remained a sizeable fraction of companies where the state remained involved. The NPF (as a legal owner) was involved in different degree in a vast number of companies over the whole period of nineties. One way, how to measure the state involvement is the number of shares the state holds in each firm that remained in the NPF, which is outlined in the Graph 1, where we present relative numbers of companies in each category of state ownership. According to this measure, the state is minority shareholder in 85% of companies (as of 1998). Number of enterprises in which the state keeps more than fifty percent of shares (majority control stake) represent only a relatively small part of all firms.

Graph 1 – Numbers of enterprises in each category of state ownership



Source: Kocenda and Lizal (2003), chapter 8.

However, this measure does not control for the size of the enterprise and takes into account only the direct state ownership. To properly assess the magnitude of the state influence over these firms we should control for the firms size as well as take into account indirect and cross-ownership (e.g., state controlled bank owns the shares, Turnovec, 1999). In addition, the state influence can be exercised by various ways. The simplest case of state influence is represented through the shares with voting rights held by the state (or state agencies). Other mean of control represents a so-called “golden” share. This is a special instrument. There exists a single share with a special status that carries a veto right on certain types of managerial decisions.⁴ There were almost one-third of such companies in the portfolio of NPF (Kocenda, 1999).

In order to properly evaluate the extent of state control we have to combine all the mentioned approaches. Result based on measures that control for the direct and indirect ownership, veto rights and relative importance of firms measured by book values⁵ of the shares issued is that the state can influence 76% of the assets; the remaining 24% are out of state reach. Although according the usual figures on the state share on GDP reported by the IMF or World Bank the state hare was abut 25% in the late nineties, this analysis shows slightly different picture. Despite the mass and voucher privatization the state managed to influence over the significant part of the Czech economy. As one of the crucial goals of

⁴ Typical companies where the golden share exists are utility companies or so-called strategic firms that enjoy a special status that stems from other legal provisions (like licensing).

⁵ Although the book value of capital is rather imprecise measure, it still gives a good information on the size and hence relative importance of the firm in the economy.

privatization in the transition countries was to remove and limit the state (and political) influence over the firms, in view of the facts, one can legitimately challenge the common wisdom of successfully complete privatization in the nineties.

Once the privatization was over, a natural process of ownership concentration begun. As the foreign investors did not extensively participate in the mass privatization, they started to appear later. This process is quite well reflected in development of foreign direct investment (FDI, described in the following section) and privatization of remaining state holdings after year 2000.

However, we should also mention two important issues related to the development of enterprise sector that were determined by the privatization design – the role of banks and the effects in firm level investment and performance. While privatization of small firms was completed successfully in the early 1990's, the large-scale privatization of the mid 1990s was plagued by asset stripping or “looting” and resulted in insufficient restructuring. Many of the old Czech firms continued to receive subsidies hidden as (soft) commercial loans.

The privatization of many large companies, including banks, was thus much slower than it appeared – despite the significant share of these companies distributed to the public in voucher privatization. In fact, in 1998, most large strategic companies were still under state control – either directly or indirectly through state-owned banks.

Lizal and Svejnar (2001, 2002) find output to be an important determinant of investment as well as retained profit is found to be a major determinant of new (replacement) investment. The fact that they only find a positive relationship between profit and investment in cooperatives and to a lesser extent the smaller private firms supports the view that that these firms encounter financing constraints. These results are consistent with the financing-hierarchy and credit-rationing hypotheses. However, the lack of a strong positive link between profit and investment across the broad range of firms casts doubt on the validity of the hypothesis that stresses a positive relationship between credit rationing and aggregate investment and output. In fact, their results suggest that larger firms had virtually unlimited access to capital and in many years it was the less profitable (more loss making) state and former state-owned firms that received more bank credit and invested at a higher rate, *ceteris paribus*, than their more profitable counterparts. Taken together with the fact that the Czech banks accumulated a large portfolio of non-performing loans, large firms had a high propensity to invest and by the mid-to-late 1990s many of them reached the verge of bankruptcy, these findings suggest that throughout the 1990s many large firms operated under a soft budget constraint.

The bank behavior has really changed after their privatization. Bank privatization was postponed (compared to enterprise sector) – in order to cushion the industries and keep the state influence on the enterprises. A retrospective view of the development of the Czech banking sector reveals that this approach brought about significant costs as the state was incapable of monitoring and pursuing the efficiency of the banks under its control. A significant moral hazard problem prevailed in the Czech state banks, which only enhanced soft budgeting (large established firms with large debts easily obtained loans and in the case of default there was a large chance of the loan being refinanced) on the one side and led to insufficient credit supply (small and new firms with smaller projects faced difficulties in negotiating with banks and obtaining financing) on the other. The moral hazard of bank management led to great problems with capital adequacy as a consequence of the subsequently-revealed bad loans. The Czech government obtained an acceptable price for the banks sold at the expense of large bailouts and portfolio guarantees given to the investors. As note in Jurajda and Lizal (2003), the explicit costs exceeded the pecuniary revenues by more than two times. It must be taken into account that the real cost of are higher: the refinancing of

non-viable projects instead of the financing of the development of small and medium enterprises is the most pronounced opportunity costs.

Effect of Privatization on Business Performance

Privatization of state enterprises is often viewed as a necessary condition for improved corporate performance. The standard argument (apart the important cut-off of the state from direct influence on the enterprise sector) for privatization is that in most circumstances private ownership leads to the best possible economic performance of firms. Recently, studies of the performance effects of privatization have been occupying an important place in the economics literature as the transition countries privatized their state-owned enterprises (SOEs) in order to improve their performance and reduce the influence of the state. The issue of how best to restructure and modernize firms has become a focal point of the debate about optimal types of ownership and legal (corporate) structure of firms in the new market economies. If firms faced soft budget constraints (willingness of the government or some other institution to bail out poorly performing firms), investment might lead to a waste of resources as inefficient firms used these funds for survival rather than restructuring.

Recently, statistical analyses have focused on the “treatment” effect of a privatization, trying to determine whether privatization improves the performance of the former SOEs, e.g., Frydman et al. (1999), Kocenda and Svejnar (2002), or Lizal and Svejnar (2002). Yet, the effect is surprisingly hard to identify and one observes a variety of findings. At the country-level, one observes that some of the fastest growing transition economies (e.g., Poland and Slovenia) have been among the slowest to privatize. Recent surveys come up with assessments that range from finding a large variation of outcomes but no systematically significant effect of privatization (Bevan, Estrin and Schaffer, 1999), to cautiously concluding that privatization improves firm performance (Megginson and Netter, 2001), to being fairly confident that privatization tends to improve performance (Shirley and Walsh, 2000). We would refer the readers to make their own judgment of the privatization effect on the performance, as there is not commonly accepted view formed yet.⁶

Role of Foreign Companies (FDI)

On the eve of World War two the former Czechoslovak economy was quite interlinked with other industrial countries. Yet, there existed differences among countries which are discussed in Teichova (1997). From the perspective of foreign investment and capital holdings we can notice remarkable differences. As Table 11 shows, the most important foreign shareholders in former Czechoslovakia were Great Britain and France that together amounted to more than 50% of the foreign holdings in Czechoslovak industrial companies. Similar situation was in former Yugoslavia, although here the Great Britain and France switched their ranking in importance and together hold slightly less than half of the foreign stakes. Quite different was, however, the situation in Poland. The French share was similar to those in Yugoslavia but the Great Britain was only a minor shareholder, replaced by the American owners. Also, Austria seems to be significant player only in the Czechoslovakia, which is probably the natural outcome of common past in the Austro-Hungarian Empire.

Foreign direct investment (FDI) inflows to the Czech Republic increased considerably in recent years; indeed, FDI reached its peak in 2002 (Table 12). The enormous slow-down to approximately one-third levels in 2003 should be explained as the general world trends and the world as a whole experienced period favorable to FDI. During the first years of the second

⁶ In addition to the already mentioned articles, interesting findings can be found in numerous other articles. Boardman and Vining (1989) and Pohl et al. (1997) compare private and state firms operating under similar conditions. Privatization in CEECs is also assessed by Claessens and Djankov (1999) Earle and Tegdy (1998), Hoekman and Djankov (1998).

millennium continuing privatization of large companies and major banks fueled the Czech FDI inflow. Large-scale privatization transactions were dominant and the expected EU accession boosted the inflow significantly. The inflow of FDI during 2002 was more than 8 bln. USD, however, about a half of this inflow comes from the sale of Transgas (the natural gas pipeline network) to RWG of Germany. In 2003, there was no large transaction and, unlike in the previous years, the 2003 figure represents current natural FDI inflow. In sum, the Czech Republic attracted about USD 36 bln. of foreign direct investment during 1993–2003, while the per capita FDI was the one of the highest within the Central and Eastern European Countries (CEECs) around year 2000.

The share of EU countries on Czech FDI reached 80% in 2002 and had an increasing tendency. Germany has the strongest position, followed by the Netherlands, Austria, and France (target industries are in Graph 2). There is relatively little investment from Japan and the US in the Czech Republic, although part can be hidden in the Netherlands FDI as multinationals often establish companies in Netherlands through which they invest abroad. It can be expected that FDI from EU will be further strengthened and will grow quickly after accession, which was the case of Spain and Portugal.

Table 11 – Origin of Foreign Investments in Joint-Stock Capital, 1937

Origin	Czechoslovakia	Poland	Yugoslavia
Great Britain	30.8	5.5	17.3
France	21.4	27.1	27.5
Austria	13.1	3.5	0*
Holland	8.8	3.5	2.1
Germany	7.2	13.8	6.2
Belgium	7.1	12.5	5.3
Switzerland	4.5	7.2	7.3
USA	3.5	19.2	12.0
Italy	2.2	0	3.1
Sweden	0.9	2.7	1.2
Hungary	0.5	0	2.0
Czechoslovakia	X	1.6	8.5
Monaco	0	0	2.9
Poland	0	x	0.3
Other countries/mixed	0	3.4	4.3

Source: Teichova (1997)

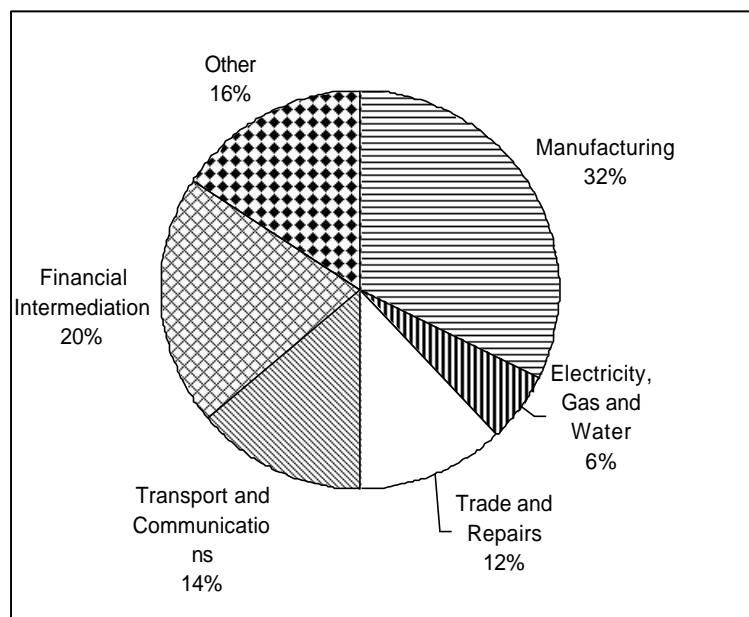
Notes: Industry and trade companies in Czechoslovakia, Industry and trade companies in Poland, Private industrial companies in Yugoslavia, * included in German share.

Table 12 – Foreign Direct Investment Inflow (mil. USD)

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
FDI	654	869	2562	1428	1300	3718	6324	4986	5641	8483	2583

Source: CNB

Graph 2 – Targets of FDI, Czech Republic, Cumulative, 1993-2003



Source: CNB

SMEs in a Regulated Economy

Additional evidences to the already presented numbers of registered enterprises should document the rapid growth and importance of SMEs in the Czech Republic. Although the data is not readily available for the whole transition period, the existing facts are highly suggestive. For example, in 1999 the net change (birth rate minus death rate of firms) was slightly above 10% in the Czech Republic, ranking it third after Poland (achieving almost 14%) and Estonia (11%); see EC (2003). In that period the EU-average was slightly below 1%. However, the volatility rate (birth plus death rate of firms) was one of the lowest in the EU and accession countries; this implies the firms do not exit in the Czech Republic.

In 2002, self-employment as a percentage of the total labor force in industry and services amounted to 12.3 % in the EU. The rate has not changed almost at all during 1995-2000, with slight decrease after 2000. The Czech Republic observed steady increase, with level of self-employment at 16% in 2002, one of the highest among transition and EU countries (only southern EU countries with long tradition of small family businesses scored higher, EC 2003).

Other measure of convergence to EU-like economy can be found in Jurajda and Terrell (2003). Their results are in line with previous findings that the firm distribution depends on the industry identity and the country identity is negligible factor in this respect. As documented in their results (excerpt reproduced as Table 13), the comparable categories of Austria and Germany look similar, and, indeed, the evolution of Czech economy drives the firm distribution towards the same result. We can see that the initial distortion towards large firms that is clearly visible in the early nineties is ceasing away and in the mid nineties the firm distribution is more similar, if not almost identical (e.g., Austrian and Czech manufacturing or mining industries distribution). The authors also found 93% correlation between new employment opportunities and industry share of smaller firms (up to 100 employees).

Although recent share of SMEs tend to resemble situation in other European countries, there are numerous drawbacks that could hinder the future development. In particular, 2004 World Competitiveness Yearbook (WCY 2004) identifies weakest criteria in which the Czech Republic is significantly lagging behind. These criteria are based both on managerial surveys

as well as on economic performance data. Out of 60 countries evaluated, Czech Republic scored 50th place or worse in several categories that measure governmental and business efficiency. In particular, extremely problematic is creation of firm (57th) and problems are in the ease of doing business (55th). Managerial practices are not ethical enough (57th), credibility of managers is low (57th) and entrepreneurship of managers is not widespread (55th).

This coincides with the relative weakness identified by EU (2003). In particular, the measures for SMEs in-house innovation or innovation in cooperation with other firms (both for manufacturing and service sectors) are at about two-thirds of the EU levels. These indicators measure the degree to which manufacturing/services SMEs that have introduced any new or significantly improved products or production processes during the analyzed. The indicator is, by construction, limited to SMEs because almost all large firms innovate and because countries with an industrial structure weighted to larger firms would tend to do better. Also, current and trend for European patents, public spending on R&D and current patents are relatively low.

Table 13: Industry Firm-size Distribution

Firm size	Agriculture & forestry	Mining & utilities	Manufacturing	Construction	Wholesale & retail trade	Hotel & restaurant	Other private services	Banking & insurance
Austria 1998								
<20	65	8	22	35	42	67	55	11
20-100	29	18	25	38	28	23	21	25
101-500	6	28	32	22	20	9	18	33
>500	0	46	22	5	9	2	7	31
West Germany 1995								
<50	85	21	24	66	58	53		22
50-99	8	9	9	13	13	14		12
100-499	6	24	27	17	21	22		31
> 500	1	46	40	4	9	11		35
Czech Republic January 1991								
<25	9	4	7	23	44	56	25	7
25-100	29	20	14	20	21	19	21	51
101-500	49	26	34	35	25	14	29	23
>500	13	50	45	22	10	10	25	19
Czech Republic December 1996								
<25	23	12	18	43	67	67	42	22
25-100	31	17	21	24	19	16	21	26
101-500	43	23	29	25	10	11	19	33
>500	3	48	32	8	3	6	18	19

Source: Jurajda and Terrell (2003)

The administrative burden hindering the SMEs can be documented both in setting up the enterprises and closing down as well as in the enforcement of business contracts, as published by WorldBank using methodology of Djankov et al. (2002), Table 14. While the Slovak Republic conducted reforms in 2003 and the duration of starting business dropped to 52 day, the Czech Republic has not took any steps to improve the situation yet. Both start-up and closure are lengthy procedures and the time burden is significantly bigger that in other European and transition countries. However, the difference is quite visible in comparison with the Anglo-Saxon business environment. Internationally comparable indices of flexibility

suggest that the Czech labor market is somewhat more flexible than those of most EU countries and transition economies. Two key problems of the Czech labor market are not shown. First, Czech taxation of labor is very high (including social and other taxes); they are much higher than the OECD average. The other problem is that the system of social assistance generates significant work disincentive effects. In this light the international comparison became less favorable after 2003 when Slovakia introduced a number of flexibility-promoting policies. On the other hand, newly adopted changes in the Czech Labor Code limited the use of fixed-term contracts and made market more rigid.

In addition, the contract enforcement in the Czech Republic seems to be well comparable to the other standard EU countries. Yet, the problem is that receiving favorable decision by a court does not imply the ability to enforce it (for that a new legal procedure has to be often started).

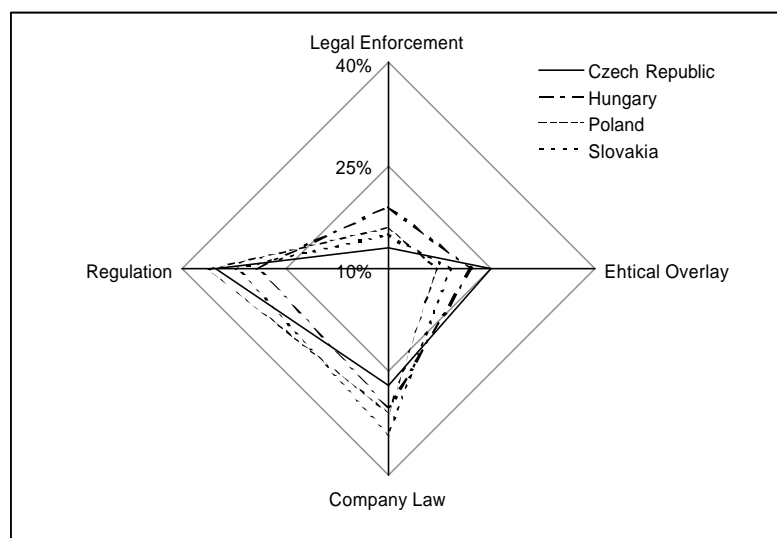
Table 14 – Conducting Business in Regulated Economy

Country	Starting a Business			Enforcing Contracts				Closing a Business	
	# of Procedures	Duration (days)	Cost (% GNI per capita)	# of Procedures	Duration (days)	Cost (% GNI per capita)	Procedural Complexity Ind. [@]	Actual Time (in years)	Actual Cost (% of estate)
Czech Republic	10	88	11.7	16	270	18.5	64.6	9.2	38
France	9	49	1.4	21	210	3.8	79.2	2.4	18
Germany	9	45	5.9	26	154	6.0	61.1	1.2	8
Hungary	5	65	64.3	17	365	5.4	56.9	2.0	38
Poland	10	31	21.2	18	1,000	11.2	65.3	1.5	18
Slovak Republic	10	98	10.2	26	420	13.3	40.3	4.8	18
Slovenia	10	61	15.5	22	1,003	3.6	65.3	3.7	18
United Kingdom	6	18	1.0	12	101	0.5	36.2	1.0	8
United States	5	4	0.6	17	365	0.4	45.8	3.0	4

Source: <http://rru.worldbank.org/DoingBusiness/>

Note: [@] This index measures substantive, and procedural statutory intervention in civil cases in the courts based on average of subindices, see Djankov et al. (2002).

Graph 3 – Corporate Governance Risk

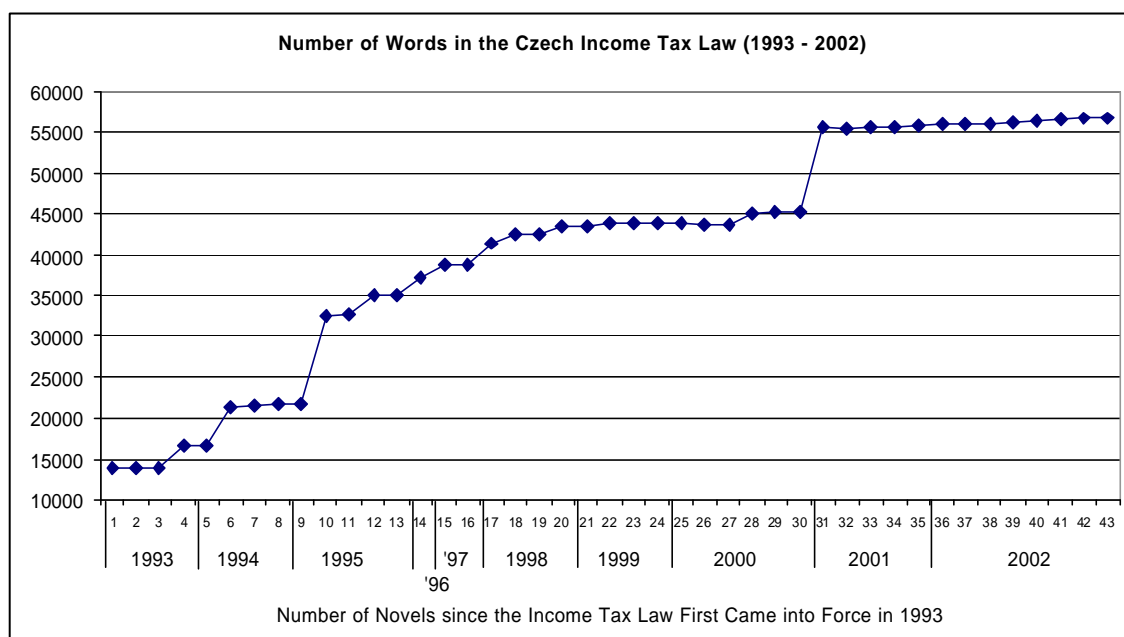


Source: Czech Republic (2002).

Such a kind of a problem can be documented with another attempt to evaluate the quality of the business environment in Central Europe. Crichton-Miller and Worman (1999) designed so-called Corporate Governance Risk (CGR) index. Four elements of corporate governance risk are core of the comparison: corporate law, legal processes, regulatory regime, and ethical overlay. The Graph 3 shows the relative importance of the four elements as revealed in the scoring using questionnaires. The diagram should be a regular square with corners at 25% levels in an economy with well-balanced quality across these four elements. Clearly the picture shows bias in favor of company law and the operation of the regulatory system. The complexity of the regulation can be illustrated using Graph 4 that depicts the increase of number of words in the income tax law during the course of 10 years after its implementation in 1993. On the contrary, law enforcement and ethical overlay are identified as problematic (Graph 3). The legal processes are extremely slow and cost-ineffective. In addition to these common features, we can find relative successes and failures of the Czech business environment compared to the legal frameworks of Hungary, Poland, and Slovakia. The most obvious failure was already mentioned and identified in other comparisons – bankruptcy law is the weakest part of the company laws. Also, law enforcement is quite serious hinder in the Czech Republic. Similar conclusion could be drawn using the Aggregate Governance Indicators (AGI) introduced by World Bank Institute in order to measure the quality of business environment. However, the AGI does not well identify the problematic areas as the WCY (2004) report or CGI index.

In sum, Czech transition from the perspective of SMEs was and is continuously characterized with problems in legal framework, namely the rule of law and an ineffective judicatory system, insufficient use of public tenders, and a general spread of corruption in public administration and commercial courts (Jurajda and Lizal, 2003). Also the European Commission tackled these issues in its regular reports on Czech Republic. In particular, proper attention should be put to improvement of the overall business environment (like company register and effective enforcement of judgments), including bankruptcy procedures.

Graph 4 – Complexity of Laws: Number of Words in the Czech Income Tax Law



Source: Czech Republic (2002).

Bankruptcies as Mean of Exit

In the neoclassical view bankruptcy should volley unproductively allocated resources back to productive sectors. This may also be the case of transition economies. Bankruptcies are sometimes referred to as a restructuring device. How much the bankruptcy procedure is used is a different question.

In the Czech Republic there was substantial growth until the last years when the number of declared bankruptcies stagnated. This rapid growth basically copies the evolution of the legal framework of bankruptcy procedures in the Czech Republic. Initially, bankruptcy was almost impossible since the government feared massive layoffs and economic collapse (Lizal and Janosik, 2001). As these fears faded and the law converged towards a standard law for the market economy, bankruptcies were more likely happen. Likewise, increasing bankruptcies have been observed in Slovakia and Hungary, although Hungary took a courageous approach and made bankruptcies easier than the other two with an automatic trigger in the early transition stage (Mitchell, 1998). Taking into account country sizes, we observe the same pattern in all these countries.

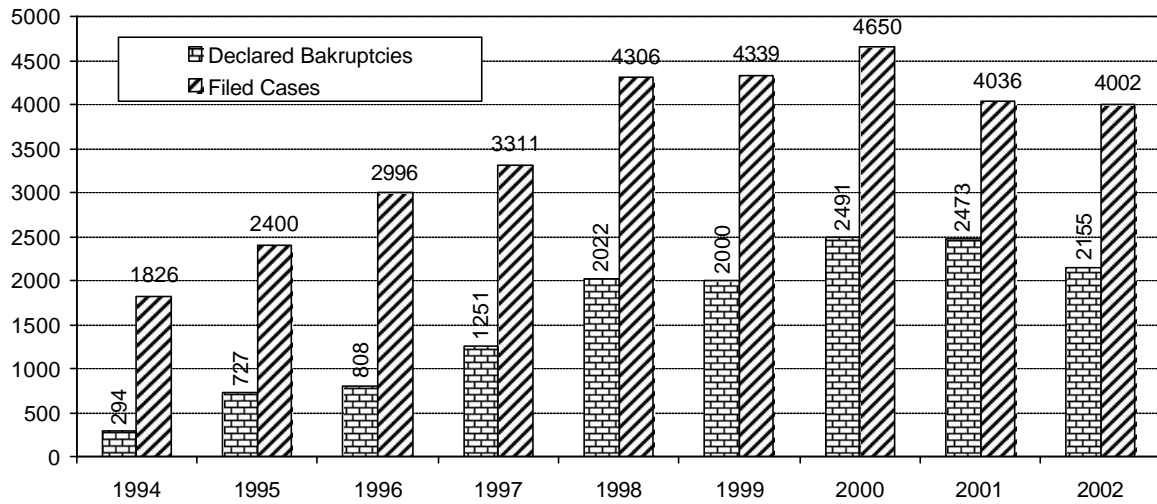
In the Czech Republic an economic crisis occurred in 1997. Yet, it was not really reflected in the evolution of bankruptcies. After rapid growth in the mid-nineties, the pace of filed and declared bankruptcies stagnated during the last year, and the actual growth from 1998 to 1999 was 0.8 %. In 1999 there were 4339 filings in total, while from 1997 to 1998 there was approximately 30 % growth (see Graph 5). Moreover, the declared number of bankruptcies lowered by 1.1 % to exactly 2000 in total in 1999. In 2000, there was a 7.2% increase in the number of filings and the number of bankruptcies as well as filings peaked in this year. The success rate is 46.1 % in 1999 compared to 47% in 1998 and grew to 53.4% in 2000. A major change can be observed in the rate of rulings made by the courts. While in the middle nineties the rate was approximately 50% and slowly increased to 60% in 1997 and then to 70% in 1999, in 2000 it reached 88%. This is clear evidence that the bankruptcy code was slowing down the decision process and the last amendment made in 2000 achieved its goal, since the economy started to grow and the recession was over. As mentioned earlier, despite the changes made, the bankruptcy procedures remains a real problem and the typical length of firm closure – 9 year (Table 14) – just underscores the prolonged problems with firms' exits (Lizal, 2001).

Graph 6 depicts the distribution of bankruptcies (filings) across the major legal categories. The major group consists of limited liability companies, which typically represent SMEs. The category other comprises mainly cooperatives of various kinds (the most frequent are aricultural ones) and special types of companies (e.g., société comandité). Over the time there is a clear pattern of the growing share of the companies with limited liability and joint stock companies, while the remaining types are less becoming present.

Summary

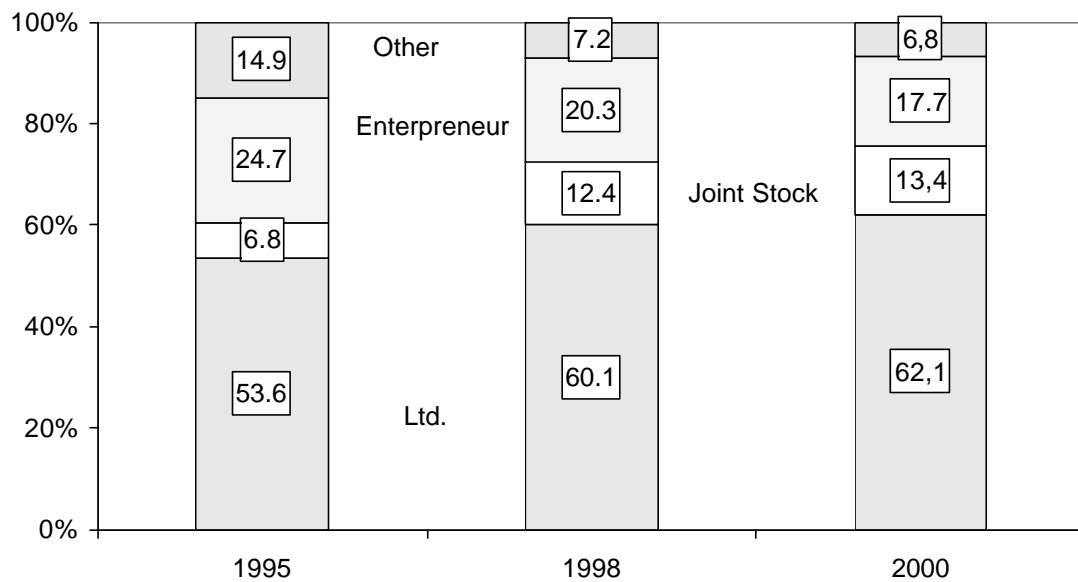
To the large extent, the development of the enterprise sector in the Czech Republic in the nineties was determined by the design of the privatization. The privatization affected not only the prior distribution of the ownership, but also due to postponed privatization of banks hampered access to credit of newly established enterprises and led to significant bail-out costs. The limited access of foreign firms to the enterprises in privatization postponed the entry of foreign firms to domestic ones and forced the domestic firms to finance their restructuring using expensive bank credit instead of new owners' internal resources. This pressure was even pronounced due to completely malfunctioning stock exchange. The legal framework remains deficient in many key areas affecting the birth, behavior, death, and prospects of SMEs. As documented, the economy is on one hand overregulated, resulting in lengthy and costly entry and exit, on the other hand the existing regulation is rarely enforceable in certain key areas leading to further business environment deterioration.

Graph 5 – Bankruptcies and Filings for Bankruptcies, cases.



Source: Dept. of Justice, Ministry of Trade and industry.

Graph 6 – Composition of Firms in Bankruptcy according Legal Status



Source: Dept. of Justice.

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