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I, the undersigned

FAMILY NAME Zuzul

NAME Ivana

Student ID no. 2000139

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The Legacies of Privatization and Liberalization in Czech Republic, Slovakia, and Hungary

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Student's Tutor Fabrizio Onida

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Doctoral Thesis, University of Bocconi

Drivers of growth in transition economies:

The Legacies of Privatization and Liberalization in Czech Republic, Slovakia, and Hungary

Ivana Zuzul
Advisor: Professor Fabrizio Onida

ABSTRACT

This thesis explores the drivers of economic growth in post transitional economies of Central Europe. In the two decades since the end of communism, the Czech Republic, Slovakia, and Hungary have developed along diverging paths. While the Czech Republic and Slovakia have achieved stable growth, Hungary has struggled to translate its early economic success into sustainable growth. This thesis draws on a qualitative, in-depth study of each state's development to propose that – while these differences have largely come to light since the global financial crisis – they stem largely from the policies and agendas set early in the transition period. The key finding of this thesis is that states that transferred stewardship of the economy to a wide array of private sector actors through rapid and inclusive privatization and liberalization programs were better positioned to achieve stable, resilient growth. These states, this thesis shows, were able to build stable economic systems marked by low inflation and deficits; respond to both external and domestic economic crises; and carry out politically difficult decisions, including cuts to government spending. By uncovering the importance of longitudinal, interconnected processes, this thesis complements existing economic research on the drivers of post transitional growth. In so doing, it demonstrates the potential of qualitative analysis in explaining whether and how particular policy choices can impact the development of states over the long term.

CHAPTER 1: INTRODUCTION

More than a decade into the new millennium, and more than twenty years after the end of Soviet communist rule over Central Europe, a profound economic disparity exists between different states in Central Europe. The Czech Republic, Slovakia, and Hungary have each established stable market economies in the past two decades, after suffering through economic downturns shortly following their transition from communist to free-market economies. Yet, the course, robustness and speed of their economic development have differed sharply. Similar divides exist across their political and institutional landscapes. Competitive democracies, underpinned by an extensive range of civil liberties and widespread political rights to participate in multiparty elections, have taken root across the region. Yet in some states, this democratic orientation belies the limited government capacity – hampered by corruption, ineffective governance, and lack of leadership – to support economic development through sound institutional and legal regimes, and policies that create space for private enterprise. Concurrently – and, in many cases, consequently – the private sectors of these states, which underwent a massive transformation from a centrally planned system to a largely free market enterprise through varied processes and speeds of privatization, have posted varying levels of success.

The wide discrepancy in transition across the region raises a series of questions that are addressed in this thesis. The central question this thesis poses is: why has the economic GDP growth of some transition countries been more sustained and rapid than the growth of others? And to what extent can these differences be ascribed to economic policy choices, rather than historic and cultural circumstances at the start of transition, transitional processes, or external economic shocks? This thesis attempts to answer these questions through a comparative case study of three countries with dramatically different growth trajectories: Czech Republic, Slovakia and Hungary. Following this analysis, this thesis considers whether and how the policy lessons from the countries that enjoyed sustained and rapid growth are relevant for states in Central Eastern Europe whose progress has been stalled or uneven. Are these lessons applicable to states outside the region? Isolating the drivers of post-transitional growth in these cases can contribute to the development of robust policy advice for today's transition economies, and can help identify and build political support for appropriate contemporary reforms.

For much of Central Europe, remodeling domestic economic systems to promote the establishment and maintenance of sustained growth, and to allow entry into the competitive global marketplace and the open market of the European Union, has been a key priority. The common heritage of socialism ensured that all countries in the region began their transition with an economic system adapted not to a competitive environment but to the exigencies of a command economy. Therefore, the Czech Republic, Slovakia and Hungary each faced a common set of challenges: the imposition of market discipline on inherited enterprises that forced them to restructure and compete in an open, global market; and the creation of new enterprises willing and able to compete without special interventions or support from the state. Moreover, to complete a transition towards fully functional, stable economies, these transitional states had to consolidate the gains of the first decade of transition and address "second generation" reform issues, such as securing control over quasi-fiscal and contingent liabilities, reforming labor and financial markets, and restructuring social expenditures.

The ways that the states met these challenges differed sharply, and in turn, produced different economic outcomes. Specifically, this thesis proposes that the Czech Republic and Slovakia – unlike Hungary – created the conditions for sustained growth through vigorously-pursued state policies of economic liberalization and privatization schemes. These programs were supported through the establishment of strong regulatory and institutional frameworks, as well as hard budget constraints, including a focus on low levels of debt and deficit, and control of inflation. Through the interaction of these four elements, the governments created the conditions that allowed (over time) for the successfully transfer of stewardship for economic growth to the private sector.

In this thesis, I propose that the economic development and relative advancement of Czech Republic, Slovakia, and Hungary over the past twenty five years have depended on four key factors: the implementation of liberalization policies that eliminated artificial support mechanisms for failing industries and opened the state to external competition and trade; the success and reach of privatization programs that transferred control of the economy to the private sector; the creation of a business environment that supports the influx of foreign investment and the establishment and continued operations of private enterprises, whether major foreign-owned firms or domestic small and medium enterprises; and fiscal constraints including low inflation and levels of public spending and debt that fostered stable economic environments capable of withstanding both internal and external crises and shocks.

It is important to note that although these variables and conditions catalyzed or hindered growth across the region, no single state managed to successfully realize and harness all of the conditions or dynamics at all times. The Czech Republic and Slovakia have struggled with implementing particular growth strategies; conversely, Hungary, which has largely failed to maintain the ambitious development agenda set out immediately after the transition, has – even in the past decade – been able to create some of the conditions necessary to sustain growth. In the global context, the economic models adopted by the Czech Republic, Slovakia and Hungary are not so disparate, nor is the divergence in their economic prospects so great. All three states have, at least in some periods, been able to capture strong growth over the past twenty years by pursuing the afore-mentioned strategies, and all three states could further advance their economic development by strengthening or additionally improving these conditions.

Nonetheless, this thesis proposes that these variables have been critical to understanding what has allowed or deterred growth in the Czech Republic, Slovakia and Hungary since the early 1990s. In addition, I propose that public and government support for these measures has been far higher and more stable in states that quickly and inclusively completed privatization programs and tied large segments of the population to the private market. Thus, where governments were able to adopt a role that supported and encouraged, rather than directed or excessively supplemented, market activity have shown higher and more stable rates of economic growth, and have been better able to recover from economic shocks.

By contrast, an unwillingness or inability of governments to push such liberalization, stabilization and privatization programs at the start of the transition period has had lingering and latent effects on future economic growth. States have remained trapped and locked into a system of unsustainable public spending and debt, financial support for unprofitable industries and enterprises, and reluctance to shed industry and welfare protections. Where only political or economic elites have captured the process and gains from privatization, much of the economic activity remains outside the formal sector, as individual agents have not been encouraged to buy-into the new market system, and corruption in both business and administrative branches remains rampant.

The remainder of this thesis is organized as follows. Chapter 2 reviews the literature on growth and development of states, while Chapter 3 provides the methodology for this thesis. Chapter 4 provides an overview of the current data considered, and outlines the economic conditions. Chapter 5 considers economic liberalization and stabilization processes in the states in question, and observes the legacies of individual approaches. Chapter 6 examines privatization schemes adopted by each state, and their short and long term effects on general economic development. Finally, Chapter 7 analyzes the policies of economic development that have served to catalyze and support private enterprise, including regulatory and institutional frameworks, and evolution of an entrepreneurial culture.

Economic growth and transition states

While a great deal of attention has been devoted to the study of transitional states (whether they are transitioning from an authoritarian to democratic regime, or from an illiberal economy to a free market), most research has focused on understanding the initial transitioning stage: that is, the policies and systems that must be in place for a transition to occur, and their immediate effects. Comparatively little work has explored differences in post-transitional development beyond the early stage, and even less study has been devoted to possible long-term outcomes of states' transition paths. The importance of the establishment of an institutional culture that can begin to lead towards secure democratic and open market systems has been long recognized. Scholars and international organizations have identified a set of activities and changes that must be realized by a transitioning state as it takes its first steps toward economic development. Yet there is little discussion or consensus about the systemic adaptations and adjustments that must follow this phase to generate sustained growth. Development criteria are predominantly externally imposed and may not be integrated into the fundamental social, political, economic and cultural principles and attitudes in a particular state for reasons that could be cultural, political or institutional in nature. States may appear to reach economic, social or political development markers; yet this does not translate into an ability to move into a second stage of development characterized by continued, stable economic growth.

This discrepancy may serve to explain the lack of insight into the drivers of differences between the development of states that can neither be classified as “developing” nations nor as fully developed OECD economies. Growth literature principally considers the necessity of factors of input or capital that must be present in order to achieve growth in low-income, developing states (although there is little consensus on what factors or inputs are most relevant to growth). Presumably, therefore, a relative absence of such factors (including, for instance, access to capital, labor, or technology) in developing or least-developed states accounts for their low rates of economic growth.

Nonetheless, numerous states have the basic capabilities to engage and enhance growth. They lack neither the frequently-cited fundamental input factors (whether land, or production capacity), human capital, nor access to technology to propel economic development. Yet some countries are better able to harness these catalysts of growth than others. A number of former Second World countries of the Eastern communist bloc continue to struggle with economic development. Others, conversely, have been accepted as OECD members (a threshold club of

First World development status). Similar deviations emerge across South America and East Asia. But we know relatively little about why certain states that possess and, indeed surpass these basic development criteria continue to move toward a pattern of stable and sustained growth, while others do not. What factors or dynamics might account for differences in the development of second-tier states? And, perhaps more importantly, what policy recommendations might stem from observing and understanding these differences?

There are many potential explanations for the different patterns of development across countries, including differences in geography, preferences, economic policies, and cultural traditions. Literature on economic policy considers the extent to which differences in policies across countries can account for the variability in levels of income and initial growth rates. But most research has generally considered the impact of one or two sources of growth, whether economic, institutional, social or cultural in nature, and has not sought out answers that effectively encompass sources of growth across these varied spheres and – critically – over time. In addition, even when potential long-term drivers of growth are determined, researchers rarely explore why they may be present or absent in particular states. Current research, to varying degrees of success, centers on the role of assorted factors and inputs on growth, but fails to consider the conditions that allow for those variables to be present and engaged as a particular state or economy proceeds through its transitional period. In other words, what conditions push some transitioning states to adopt policies conducive to economic growth?

The lack of academic emphasis on this development process has been reflected through international institutions. Although globally recognized development markers may classify states as functional liberal economies, they fail to appreciate the framework, capacities and performance of their domestic structures. The 2008 economic crisis exposed weaknesses in the financial, economic, legal and political institutions of certain countries that had been previously categorized as stable developed nations. Most notably, EU membership has not necessarily assured the creation of mature, capable and efficient political and economic systems across the continent. The international response to weaknesses exposed during this crisis was the creation of further economic, financial and institutional standards that must be met by EU members as a precursor towards receiving EU aid. Nonetheless, the question of *why* these divergences between the economic development of states that share the same basic political and economic principles arose in the first place remains relatively under-theorized.

This thesis engages these questions through reflecting on case studies of three post-transitional European states. After the communist regimes collapsed throughout Eastern Europe and the former Soviet Union, they were replaced, at least initially, by relatively wide-ranging democracy. By 1993, barely 3 years into the transition, two frontrunners – the Czech Republic and Hungary – attained a level of political freedom and civil liberties comparable to the United Kingdom, France or Germany. Although other post-communist countries, including Slovakia, did not democratize quite so rapidly, they nonetheless made considerable progress. Moreover, these three states, like much of the region, succeeded in sustaining at least a moderate level of democracy, despite very turbulent economic and political developments. All post-communist countries experienced dramatic contraction of economic activity at the outset of the reforms. Subsequently, however, transition paths diverged considerably: while the Czech Republic, Hungary and Slovakia grew impressively in the early years of the transition, the Czech Republic experienced a dip in growth toward the end of the 1990s. The Czech Republic was able to recover rather rapidly, and continued to post relatively impressive growth and convergence with EU standards. Slovakia's progress has been somewhat slower, but the state has managed to sustain continued and stable economic growth, and has recently emerged as a frontrunner of economic development in the region. These two states are commonly held up as success stories of economic development in Central Europe. Hungary's status as an economic leader of the former Communist bloc has been shattered since the global economic depression in 2008, with the economy plagued by sluggish or negative growth, and its political agenda moving further away from EU and market democracy standards.

The empirical literature on Eastern Europe, spurred by the initial contribution of De Melo et al. (1996), has focused primarily on the impact of the choice of reform strategy (shock therapy vs. gradual reform) on economic performance during transition. De Melo et al. showed that greater liberalization was associated with higher growth and lower inflation, a finding that inspired a host of subsequent contributions reaching similar conclusions. However, later studies (Fidrmuc, 2003) have suggested that although liberalization of Eastern European economies showed a positive and strong correlation with growth in the immediate aftermath of the transition, by the end of the first decade of independence, its significance had diminished or disappeared. But literature on whether initial conditions had an impact on economic growth has focused on understanding the determinants of a successful *start* of the transition. Indeed, the Czech Republic, Hungary, and Slovakia shared many of their initial attributes, and did not suffer highly disruptive events such as military unrest or political coups.

This thesis considers the policy differences that have resulted in more or less sustained and rapid economic growth in these states since their transitions. The initial conditions of geography, history, price and output distortions at the start of transition, the external economic shocks arising from the breakup of the Soviet Union, and presence civil strife have, of course, contributed to or deterred economic development of each state. However, this thesis will show that while preliminary conditions were may have impacted the initial period of output decline (1990 – 1994), they have proven far less consequential through the full ten years of transition, and in the period following the states' entry into the European Union (even after accounting for differences across countries in policy reform and the impact of external economic shocks).

This analysis also demonstrates that in the transitional and post-transitional period, differences in economic growth were driven by policy reforms. Market-oriented policy reforms not only sped up economic recovery and promoted growth in the medium term, but also mitigated the effects of the transitional recession in the short term. This thesis describes the most important of these policy reforms: economic liberalization and privatization, supported by strong entrepreneurial sectors and cultures, and hard budget constraints aimed at promoting fiscal stabilization. In addition, this thesis shows that the four reforms were interconnected, reinforcing and amplifying each other's effects. This thesis therefore proposes that states' willingness and ability to commit to and continually invest in a combination of these reforms was critical in driving sustained growth.

After reviewing the literature and describing the method and data that gave rise to this analysis, this thesis considers the role of economic liberalization in fueling post-transitional growth. Full economic liberalization is a necessary precondition to the establishment of a functional market economy; as such, it was undertaken by each of the three states in question at the start of the 1990s, albeit with different priorities and rates of progress. Certain states, in particular Hungary, attempted to initially shield some strategic industries or sectors from full liberalization and competition. Furthermore, the task of building full market economies proved to be protracted, and the results of the first years of transition were uneven. Liberalization of trade and prices came quickly, but institutional reforms in areas such as governance, competition policy, labor markets, privatization and enterprise restructuring often faced opposition from vested interests. All countries suffered high inflation and major recessions as prices were freed and old economic linkages broke down. However, the scale of output losses and the time taken for growth to return and inflation to be brought under control varied widely. Initial conditions undoubtedly played a role in the management of economic liberalization, as some states, notably Hungary, had far more experience with private sector operations than others, and better economic and social ties with countries of Western Europe rather than the former USSR. Yet taking into account these differences – which in the case of Czech Republic, Slovakia and Hungary were relatively minor – it is evident that Czechoslovakia, which undertook more front-loaded and bold reforms was rewarded with faster recovery and income convergence. The Czech Republic and Slovakia further demonstrated a superior ability to recover from external shocks such as the 1997 crisis in the former, and the global 2009 financial recession that swept across the region.

Additionally, governments in the Czech Republic and Slovakia were able to embrace specific monetary and fiscal policies as part of their liberalization and stabilization packages, designed to propel growth regardless of political pressures. Data from the Czech Republic, Slovakia and Hungary demonstrates that the most crucial of all economic considerations in post-transition states was the implementation of hard budget constraints, particularly deficit and inflation measures, that contributed to financial stability. In contrast to the turbulence of the first decade of transition, the early and mid-2000s saw uniformly strong growth. With macroeconomic stability established and key market-based frameworks largely in place, the region experienced large capital inflows, supported by a benign global environment and increasing confidence in rapid convergence with Western Europe. Still, the widespread foreign bank ownership that brought much-needed credibility and technical know-how, and facilitated the provision of financing to the region, caused excessive lending and increasingly imbalanced growth. The resulting vulnerabilities were exposed when the global and euro zone crises struck at the end of the decade, hitting the region harder than any other.

Next, this thesis considers the role of privatization schemes across the region. The states in question each adopted a specific and unique plan of privatization, contingent both on economic realities and political pressures and priorities. Mass privatization was carried out initially in Czechoslovakia and subsequently in the Czech Republic through a voucher program; Slovakia later abandoned the plan in favor of direct sales. Direct sales to foreign actors was likewise favored in Hungary, after the state suffered through several attempts to initiate and catalyze privatization through different means. All experienced significant losses due to failures of the privatization plans, whether in the immediate term, such as in Slovakia, or in the mid or late term, as in the Czech Republic and Hungary, respectively. Much academic attention has been devoted to the relative advantages and speeds of these programs, with often inconclusive results. Nevertheless, the lesson drawn from the analyzed states mirrors that of economic liberalization: states that acted to transfer ownership of the economy to private entities were far more successful in encouraging a vibrant private, free-market sector, and were better able to create government programs, institutions and policies that catered to the demands of new economic actors, rather than former interest groups.

Together, these two chapters suggest that the transition to an effective, profitable and productive system of private enterprise did not directly hinge on type of liberalization or privatization. Yet the form of schemes proved critical in setting the ability of the private sector to drive further economic change, growth and policies. For instance, rapid privatization schemes that introduced new owners led to economic systems that had three critical elements: 1) an ability to restructure failing enterprises; 2) access to prudent bank lending and external investment; and 3) incentives for the government to take a supportive role in administering the economy through the establishment of proper institutions and regulatory frameworks. Through a dual commitment to extensive economic liberalization, and complete privatization, states found that even in the face of political instability or government change, the economy was permitted to develop in a stable and predictable manner. Liberalization and (inevitably far from perfect) privatization were preferable to allowing private interests to move into the vacuum left by the collapse of central planning and administrative control, by stripping assets of public companies and extracting rents from price and trade distortions. And importantly, where pursued vigorously, the broad-based reform agenda allowed the emergence of brand-new firms, which became the engine of growth as recovery took hold.

Finally, this thesis considers the role of specific political and fiscal policies in supporting entrepreneurship. In the Czech Republic and Slovakia, the shift of the government role from central planning and administering economic activity to supporting the development of private enterprise and investment led to the design and execution of institutional, legal and regulatory frameworks that stabilized the economies. The establishment of market systems that appropriately govern private sector activities through relevant bankruptcy, banking and lending, and anti-corruption measures was largely contingent on this step. Moreover, their governments acceded stewardship of the economy to the private sector, and have been better able to make continuing changes to labor and social policies, investments in key sectors and infrastructure, and management of a healthy financial sector that are able to propel and sustain growth. Vibrant entrepreneurship and support for critical and new industries and firms can thereby be traced to the initial dedication of these governments to the process of free market creation.

The speed of recovery during the financial crises of 1997 and 2009 depended predominantly on the economic and fiscal policies that had preceded the crises: the extent of fiscal accommodation depended on the available fiscal space, defined as higher primary balances and lower public debt levels, in the given country. States with limited fiscal space, such as Hungary, were forced to adopt fiscal adjustment measures to boost market confidence in their policy frameworks. Yet in these measures, too, the Czech Republic and Slovakia were more responsive to emerging challenges. External and internal shocks are an inevitable part of economic development; what the three states analyzed in this thesis showcase is that what has most mattered in achievement of economic growth has been the ability of governments to quickly react to difficult conditions. Next, this thesis reviews the literature on growth in order to help ground the discussion of differences among the three states.

CHAPTER 2: LITERATURE REVIEW

Understanding the drivers of economic growth

The search for explanations of causes, differences in magnitude, and variations in speed and sustainability of states' economic or GDP growth has spawned a large literature. Initial studies in the field of economic research typically focused on exploring independent variables related to states' use of classic production factors such as natural resources, labor and capital. Indeed, capital accumulation has been the central component of economic growth theory; the Harrod (1939)-Domar (1946) model posited a lineal relationship between the accrual of capital through investment and economic growth. Rostow (1960) introduced the concept of five distinct stages of development, the most critical of which he identified as the third "take-off" stage of industrialization and technological break-through. According to Rostow, states that fail to achieve this phase become trapped in a cycle of poverty; consequently, spurring "take-off" though capital accumulation, whether through domestic investment or external support, would lead a state towards higher rates of development. [Rostow later added a sixth stage of "quality," characterized by the continuous improvement in the quality of goods and services (Rostow 1971).] This body of research was adopted into the 1972 World Bank Revised Minimum Standard Model that explicitly linked investment and growth through a mathematical formula, and calculated the "required" amount of foreign based on a particular state's capital output ratio.

Subsequent authors deepened the dominant role of capital by emphasizing the importance of balanced growth through investment in several key industries, notably both agriculture and manufacturing (Nurkse, 1953), and of creating and promoting nascent industries through the transfer of unlimited labor from the subsistence to the capitalist sector (Lewis, 1954). The famous Solow (1957) neoclassical growth theory expanded the production function model to include both traditional production factors – labor force and capital per worker – and exogenous technological progress that shifts the frontier of steady state, and so enables further economic growth. Additional exogenous growth models (Cass, 1965; Koopman, 1965; Diamond, 1965) have similarly focused on the amassing of capital, and the existence of convergence between rich and poor states. The convergence hypothesis suggests that countries differ from each other only in their ratio of capital and labor ratio, and have the same steady state (Barro, X. Sala-i-Martin, 1992; Mankiw, Romer, Weill 1992). Indeed, a common thread throughout exogenous growth theory has been a form epistemological universalism that assumes states follow the same basic path of development despite greatly varying internal conditions; Solow, for example, postulates that technological progress globally occurs at the same rate. The models thus largely been found to have little explanatory power in considering massive divergence between growth rates across countries.

In contrast, new growth theory (Sala-i-Martin, 2001) argues that economic growth and deepening deviation between countries is mainly the result of endogenous factors including the accumulation of human capital, innovation and knowledge, diversity of institutions favorable to an economy, and free movement of such factors as capital, information and technology, without diminishing marginal returns. While this body of work has accepted the basic tenant that growth depends on the accumulation of physical and human capital and technological capacity, it highlights the importance of individual or state agency, noting that endogenous choices particular to individual states are the principal drivers of growth. Perhaps the most notable proponent of such endogenous growth theory is Schumpeter (1934), who assigned great importance to the entrepreneur, calling him a “hero of development” responsible for generating technological innovation and, ultimately, economic growth. Schumpeter emphasized the need for frameworks of private property, a competitive market, access to credit, and efficient financial markets to support the production of new inventions.

Other models affirm the necessity of investment in capital as a determinant of growth. Romer (1993) establishes a New Growth Theory that posits economic growth stems from increasing returns associated with new knowledge and transfer of ideas, where the quantity of knowledge is connected to investment rates. Lucas (1986) and Rebelo (1991), drawing on prior research (Arrow, 1961) similarly suggest that the technical level of an economy is the result of investment decisions and the capabilities of human capital. Societies that generate and tolerate new ideas, and that continuously adapt to changing economic and technological circumstances, are better predisposed to sustained economic growth. The policy prescriptions by these authors have thus largely stressed the consequence of education in economic growth. In contrast, Aghion (1991) argues that economic growth is driven by technological progress, which in turn is ensured by competition between firms, generating and implementing long-term products, and technological innovation. Yet despite differences in the importance assigned to individual factors, the overall conclusion of this endogenous growth research has been that countries characterized by a low level of human capital and technological investment grow more slowly than countries with considerable resources devoted to these spheres, and convergence between states may hence not be possible.

Still, the idea of policy preferences as engines of economic growth underpins both the endogenous growth theory and the neoclassical growth theory. Neo-classical models, however, highlight the connectivity between economic factors and institutional and market environments in which individuals, officials, and enterprises operate. In this vein, the theory shifts the focus from ideas to the “quality” of institutions as the primary explanation for differences in the levels of productivity and economic prosperity among countries and firms. Espousing this theory, North (1992) outlines a New Institutional Economics approach, arguing that growth is determined by a path-dependent approach contingent on strong network of property rights, market structures and decentralized, democratic governance. The potential of a country thus often remains unexploited without a proper institutional environment that encompasses protections for and enforcement of property rights (see Olson, 1996 and Soto, 2000 in Ticha, 2012). Moreover, the ability to deploy present resources in an economy rests not only on current regulatory standards, but historical traditions of property rights, and cultural customs of ownership (North 1990) that shape new measures and approaches. The centrality of property rights has not been dismissed, nor has the source of their ownership, whether private or public, been agreed upon with the dissolution of the Soviet sphere. Discussion on whether states or private enterprises more efficiently allocate and deploy property in service of general economic growth persists (Ticha, 2012).

Rodrik et al. (2004), building on research by Hall and Jones (1999), Kaufmann et al. (1999), Acemoglu et al. (2001, 2002), have attempted to directly measure the contribution of institutions to production and productivity, although they take care to interpret their results as correlational rather than causal. For instance, Acemoglu et al. (2001) find that institutions such as the legislature and the judiciary are strongly related to state incomes, and emphasize the role of initial institutions in determining current institutions. However, they also note that despite a strong correlation between institutions and economic performance, “there are a number of important reasons for not interpreting this relationship as causal. First, rich economies may be able to afford, or perhaps prefer, better institutions. Arguably more important than this reverse causality problem, there are many omitted determinants of income differences that will naturally be correlated with institutions. Finally, the measures of institutions are constructed ex post, and the analysts may have had a natural bias in seeing better institutions in richer places” (pg.1379-1380).

Other scholars have gone further in arguing that institutions related to state governance are the primary drivers of growth. Marshall (1925) marked the first attempt to consider the impact of governance on economic growth, identifying education and wage levels as critical to ensuring accountability of officials. Kaufmann et al. (2003) reject Marshall’s proposition, and instead elucidate six indicators of quality of governance: (1) voice and accountability; (2) political stability; (3) government effectiveness; (4) regulatory quality; (5) rule of law; and (6) control of corruption. However, Brunetti et al. (1998, pg.2) point out, “These second kind of indicators are likely to reflect more closely the concerns of entrepreneurs than the overall measures of political instability. However, they are based on the perceptions of country experts and not on those of local entrepreneurs themselves.” They also observe that political instability may not necessarily cause any uncertainty since, quite often, even coups and assassinations of political leaders do not change the investment environment.

However, Glaeser et al. (2004) challenge these contributions. In a review of the findings of Acemoglu et al. and Rodrik et al., they posit that their measures of institutions are flawed, the instruments used for institutions are inappropriate, and human capital rather than constitutional constraint on the executive, is a better predictor of economic growth. Banerjee and Iyer (2005), similarly find that good institutions alone do not lead to economic growth. Instead, both propose that growth is driven by political choices of various agencies, although they allow that institutions may lead to the selection of particular policies.

Understanding the drivers of economic growth in transition states

When these explanations have focused on states in transition, they have generally considered the characteristics of countries at the beginning of transition, and the effect of policies enacted to facilitate the transition. The political economy of post-socialist transition has also been examined to explain why economies may be trapped in situations of partial reform between planned and market based regimes, where the early gainers from reform vigorously oppose further progress toward a market economy. Characteristics of a country, whether – like geography – indelible, or determined by nature or length of the communist economic regime, at the start of transition may ineludibly shape its economic progress. De Melo, Denizer, and Gelb (1996) identify certain initial indicators as possible drivers of differences in transitional states, and aggregate them into three basic groups: structure, distortions, and institutions. Structure includes factors such as the share of industry, the share of trade with the socialist block, the richness of the natural resource endowment, the degree of urbanization, and the initial income. Economic distortions encompass variables of repressed inflation, measured as the difference between the increase in real wages and real GDP between 1987 and 1990; black market exchange rates; terms of trade loss stemming from the disbanding of the Soviet Union common market; reform history under the centrally planned system; and pretransition growth and stagnation rates. Finally, institutions are measured by market memory and years spent under communist regimes; location and historical, cultural and economic links to Western markets; and experience with nationhood and political consensus.

The question of whether initial conditions or reform policies have led to alternative economic outcomes in the Czech Republic, Slovakia and Hungary is critical in considering prescriptions for states seeking to undertake economic transitions. In 1996, the World Bank introduced a liberalization index (de Melo et.al., 1996a) to quantify and expound on the transition progress in the former Soviet bloc, with scores ranging from zero to one, where zero denotes an unreformed, centrally planned economy, and one identifies a system that meets the basic standards of a market economy. This index identifies and measures progress in basic transition reforms designed to move economies to the private sector and encourage private production, eliminate central planning and state directives, and transfer control of resource allocation to the markets. The index moreover covered modifications deemed necessary to the continued stability of the market environment, including economic liberalization and stabilization.

Building on this attempt to quantify and grade transition reform, a number of pivotal works deployed cross-country statistical analysis to study effects of policies. A preponderance of such literature determines that good policies, complementing or superseding initial conditions, have been significantly correlated with better GDP growth across the former Soviet Union, even when controlling for exogenous variables including external shocks. de Melo, Martha, Cevdet, Denizer, and Alan Gelb (1996a) and (1997) provide the definition of policy reform and initial conditions most commonly used in the literature: firstly, they demarcate the Liberalization Index as a weighted average of reforms in internal markets, external markets, and private sector entry, including privatization. Secondly, they provide a set of 12 indicators to describe the condition of the economy at the start of the transition, including natural resource endowment, location, “age” of states, urbanization, years spent under central planning, levels of over-industrialization, shares of trade with the Soviet Union, pre-transition reforms, income, initial repressed inflation, black market rate for foreign exchange – although this mass of data is reduced to two sets of variables, initial conditions and policy reforms, to ease statistical manipulation. Yet while this process grants allows for greater statistical power, it precludes the possibility of resolving which initial or reform measure has significant (or, indeed, any) impact on growth.

De Melo et.al. (1997) present a model where growth in Central and East Europe between 1992 and 1995 is explained by initial conditions; policy reforms, as quantified by the cumulative value of the Liberalization Index; and a war dummy variable. [A model for growth and the Liberalization Index is estimated, but finds a negligible simultaneity bias on the growth equation.] Both initial conditions and the Liberalization Index are found to have a significant impact on economic growth. Finally, the authors develop a “patterns of transition” model (1996b) for 26 European and Central Asian countries, with an addition of China and Vietnam, setting exogenous variables as the Cumulative Liberalization Index (CLI), on a scale from zero to one; and dummy variables for regional tension, and for Central and Eastern Europe. Interestingly, the analysis comes upon a discontinuity when CLI = 0.4, characterized by the authors as a highly general point at which states move from a “nonreform” to a “reform” pattern of growth. Indicators have a positive impact on growth only when economies move between patterns, and across the CLI threshold. Below the this point, additional reforms depress growth. The arguments that policies of reform within patterns are equal, and that policies are irrelevant to growth are hence strongly rejected.

Other studies largely support this conclusion. However, they do not necessarily reach consensus regarding which policy factors are significant at what time. Aslund, Anders, Peter Boone, and Simon Johnson (1996) thus find variations in causes of output between 1989-1995, when there is significant correlation to policy reforms, and end-of-period output levels, when liberalization and inflation appear significant. Campos, Nauro, and Coricelli (2000) perform a statistical analysis using the contemporaneous Liberalization Index to conclude that only inflation is significant, with a negative effect on growth. Additionally, they find institutional variables of the rule of law and quality of bureaucracy to be both significant and positive. Fischer, Ratna, and Veight (1998) find that the Liberalization Index and stabilization factors of inflation and fiscal deficit are significantly associated with growth, notwithstanding differences in “reform time” that reflect the uneven start of the transition process across states. Hernandez-Cata (1997) confirms the significance of liberalization and stabilization programs in all former Soviet states. Selowsky and Martin (1998) combine cross-section and time series data models, which controls for initial conditions and accounts for the possibility of a delayed effect of reforms, to conclude the Liberalization Index, and particularly its long term impact, is highly significant in economic growth; differences are evident – and reform more powerful – between Central and Eastern Europe and the CIS.

Havrylysyhyn and van Rooden (1999) extend the impact of reforms and initial conditions (aggregated as in de Melo et.al.) to institutional development, operationalized through: the Heritage Foundation’s 1994-1997 Index of Economic Freedom indicators including democracy and rule of law; institutional conditions described by the World Bank 1998 Knowledge for Development report; and country risk ratings from Euromoney. They determine that macroeconomic stabilization and comprehensive economic reforms are critical statistical drivers of growth in transition economies. The implementation of a sound institutional framework plays a significant, but lesser, role in affecting growth, especially once stabilization and liberalization policies are accounted for, and treated (as in this thesis) as the result of government strategy and not institutional development.

Berg, Borensztein, Ratna, and Zettelmeyer (1999) explore annual growth rate and GDP levels within the former Soviet Union states between 1991 and 1996, and generate a model that includes macroeconomic factors, including fiscal balance, inflation, and exchange rate regime; structural reforms as defined by the Liberalization Index; initial conditions derived from de Melo et al. (1997); and controls such as average OECD growth, terms of trade, and dummies war and conflict variables. The authors moreover allow for lags in both macroeconomic indicators and structural reform indexes, and parameterize initial conditions to illuminate a rise or decline in their impact over time [though much of the specific analysis is not published]. by time to allow for their impact to decline or dissipate after a period (but the precise specification and statistical tests are not published with the paper). The presence of the multitude of variables precludes the extrapolation of significant results for any individual factor, but permits the dismissal or validation of a category of variables in their impact on economic development. Berg et.al. strongly reject the premise that no macroeconomic or structural indicators matter. As variables with low statistical significance are eliminated from the model, differences in policies rather than initial conditions emerge as the primary drivers of variability in growth, and explain the variances between Central and Eastern Europe and the CIS.

In a rare counterexample, Heybey and Murrell (1999) find that average growth in the early stages of the transition is not correlated with the Liberalization Index when endogeneity of liberalization policies, defined as the initial degree of liberalization, economic structure, and levels of political freedom, is considered. The authors summarize that initial conditions are “much more important than policy variables” (pg.15). Yet it should be noted that the authors concentrate exclusively on the first four years of the transition, when states experienced economic shocks and contractions. The findings may thereby be inapplicable for later phases of the transition and the post-transition period.

Thus, while studies generally conclude policies have significant effect on subsequent economic progress, they do contain some disagreements on the relationship between policies and growth. The empirical analysis by de Melo et.al. (1996b) offers a possible solution to this discrepancy that may integrate incongruent findings: there may be a minimum level of reform, or stage of transition, that must be in place before reforms can truly bear influence on economic development. An incomplete transition, or the adoption of a few incoherent reform measures, may be unable to meaningfully affect the market, and may indeed have a negative impact on growth. The interplay between programs of a market reform, and the interconnectedness of factors that influence economic development may be the critical element to understanding what drivers of growth are and how they may be engaged. No empirical study has yet attempted to elucidate these networks.

Furthermore, the true impact of policy reforms may not be visible in the immediate stages of transition. Empirical analysis suggests the presence of a delay in determining the effect of reform policies on economic growth; Selowsky and Martin (1998) reject the hypothesis that the effect if contemporaneous, and Heybell and Murrell (1999) suggest that the time lag might be as long as four years. can be strongly rejected; see Selowsky and Martin 1998). Regional differences between start of reform impact are also evident – CIS states suffer from greater delays, consistent with their worse starting positions and subsequent challenges, though such variations are not relevant in this thesis. In fact, this finding is intuitively logical based on economic patterns observed in states in transition: factors that cause set initial economic performance may not be determinants of growth in later stages. The obstacles and conditions present early in the transition may have a particularly adverse income before economies have the opportunity to stabilize and enact appropriate reform. However, it is likewise possible, as this thesis will demonstrate, that some measures passed in these initial phases may have delayed and substantial effect on long term economic development.

A more recent review of data yields the following insights. First, initial conditions appear to be more relevant in explaining the differences across countries during the initial period of output decline than over the full 10 years of transition. A World Bank (2003) study performed a decade into the transition process, using initial condition indicators developed by de Melo et.al. (1997), and the terms of trade loss estimated by Tarr (1994), attributes 51% of variance in average growth across countries between 1990 and 1994 to initial structures, distortions and institutions, with 44% of variance attributed to such initial conditions between 1995 and 1999. Second, different elements of initial circumstances vary in their significance across stages of transition:

initial distortions including repressed inflation and absence of pretransition reforms, are correlated with differences in growth in the early phase, while initial institutions, as described by Havrylysyhyn and van Rooden (1999), are associated with growth variance toward the end of the decade. Third, the effect of reform measures is heightened, and perhaps compounded, in the second stage of the transition, starting in 1995, though their impact is still significant in the early period. Indeed, market-oriented policy reforms not only speed economic recovery and promote growth in the medium-term, but also mitigate the effects of the transition recession in the short term. Therefore, it should be necessary to perform an in-depth study of policies pursued by various states during the process of their transition in order to better answer what factors or conditions allow for the stable development of post-transitional states.

This Thesis

This thesis attempts to fill the gap in the data by highlighting the processes that allowed certain reforms to emerge and take root; that eased the enactment of the next steps of reform; and that permitted the establishment of a sound market system that can successfully drive growth. The thesis will isolate the effects of initial conditions from policy decisions in exploring the drivers of post-transition growth in the Czech Republic, Slovakia and Hungary. In particular, the unbundling of initial conditions into structure, distortions, and institutions provides a more nuanced answer to the question of the importance of initial conditions versus policy reforms in explaining the recession and recovery periods of the transition experience. Because of the relative similarities of the Czech Republic, Slovakia and Hungary at the start of the transition, many of these factors – and particularly those related to structure – can immediately be eliminated as possible explanatory variables when accounting for differences in economic outcomes. The share of industry in GDP was artificially high across the region as trade, financial services, and business and consumer services were repressed under centrally planned economies. Trade was almost exclusively limited to other communist countries, as shown by the ratio of Council of Mutual Economic Assistance exports and imports to GDP. All three countries exhibited relatively similar high degrees of urbanization and low natural resource endowment, and comparable levels of income. Hence any real variation in their development may be attributed to agendas, policies, and reforms designed and implemented during their respective transitions.

CHAPTER 3: METHODOLOGY

Justification

Most research exploring the drivers of national economic growth is anchored in economics, and consists of regressions linking specific independent variables with levels of GDP growth across countries. Due to the variability of parameters, rapid changes in the aggregate magnitudes and economic and structural relations, and newly emerging conditions, this field of research has often been labeled the “endless frontier” (Kuznets, 1972). This thesis compliments and extends more traditional research on the catalysts of growth by employing the archival comparative case method. That is, rather than testing hypotheses about the drivers of growth quantitatively, this thesis draws on in-depth data from three countries to build new theoretical insights into growth in post-transitional countries.

Three facts justify the use of the comparative case method. First, many drivers of growth are difficult to quantify, and studies drawing on different measures sometimes arrive at inconsistent results. Little consensus exists on whether development of a state should be considered merely through economic indicators, or should encompass gauges of societal stability and welfare. In the case of the former, the challenge lies in selecting appropriate data from variables as vast and disparate as labor inputs to fiscal measures. In seminal studies on transitional economies, scholars have widely disagreed on what factors might be relevant, and how they may be quantified. For instance, whereas Denizer (1997) does not include inflation in growth regressions, Aslund, Boone, and Johnson (1996) develop models that include the economic liberalization index and exclude inaction and vice versa, and Christoffersen and Doyle (1998) and

Hernandez-Cata (1997) include the log of inaction. In addition, regression-based studies tend to focus on exploring the impact of variables that can be meaningfully quantified – meaning economic indicators rather than social, political, or historical drivers of growth. These “softer” drivers are difficult to quantify and meaningfully compare across countries; they are thus often excluded from analyses. Yet post-transitional growth might be affected by many historical and cultural processes – the leadership of individuals and organizations; legacies of central planning and authoritarian rule; selection of particular economic targets – that cannot be assessed quantitatively. Regression studies that consider these factors usually rely on aggregated survey data, and encounter several methodological and theoretical problems (Silver and Dowley, 2000).

Second, economic studies often fail to take into account the relationships between different drivers of growth. While quantitative studies can estimate relative effect sizes of different independent variables and their interactions, these associations are not necessarily causal. Economic research is frequently faced with the problem of endogeneity. Do economic, political or social conditions lead to the selection of particular economic objectives or preferences, or do such preferences create specific circumstances? Complex economic issues are often inextricably linked and bound by a causal loop. However, broad quantitative studies that attempt to reduce these processes to computable measures are often unable to determine what variables, choices or behaviors lead to, or are a product of, existing conditions. For instance, cross-national studies of transitional states find a negative relationship between growth and inflation in post-communist countries but differ on whether to treat inflation as the independent variable (Katchanovski, 2000). Even if a causal order can be determines or approximated, such large-N studies are generally unable to illuminate why particular variables are engaged in some settings or states and not in others, and what linkages are important.

Finally, and most critically, qualitative methods are most useful for evaluating *how* particular processes unfold over time (Yin, 2013). Although quantitative studies can assess relationships between specific variables, they cannot speak to the multifaceted ways that these relationships might shift or transform over time. Even if variables at the start of transition period – for instance, levels of trade liberalization – are fixed, countries might manipulate them in different ways over time that lead to markedly different outcomes. Post-transitional growth is a multifaceted and compound process that has unfolded over time – the same inputs can lead to very different results depending on how they are used, harnessed, suppressed or encouraged. Scholars have identified a set of variables that must be in place if a transitional country is to reach the post-transitional stage, the liberalization of prices and trade, and privatization of enterprises being the baseline of a market economy. Yet little is known about the *process* through which these variables can be transformed, adapted, and adjusted to generate sustained growth in the post-transitional phase. By employing the comparative case method, this thesis will fill this gap.

Cases

To do so, this thesis draws on detailed archival data about three countries: Czech Republic, Slovakia, and Hungary. Multiple-case studies allow for comparisons across cases that can result in robust, generalizable theory about the processes that can drive different outcomes in similar settings (Yin, 2013). The three countries were chosen because there are sufficient similarities between them to allow for meaningful comparison. At the demise of the communist bloc in Europe in the early 1990s, all three of these states emerged from a system of central planning and state ownership of economic assets with relatively similar economic performance. GDP per capita in 1989 was rather similar and well below the Western European average, standing at approximately $6500 in Hungary, and $8500 in Czechoslovakia. All three states had suffered from economic stagnation throughout much of the 1970s and 1980s. Economic output was likewise comparably structured, with heavy industry dominating services and high value goods, and exports oriented toward the Eastern bloc. Finally, all of the states shared a economic, cultural and social past, having been united within a single kingdom prior to the establishment of the first Czechoslovakian state in 1918.

Communist regimes had evolved in somewhat distinct ways across the region – Czechoslovakia had been subjected to a particularly repressive, Moscow-dominated regime, while the Hungarian communist parties operated far more independently – but had all engaged in a systematic program of destroying institutions, social fabrics and cultural foundations that could facilitate and support liberal political and economic systems. The EBRD awarded each of the three states the same score across all initial transition indicators. Thus no state entered the transition period with a modern tradition of civic participation and institutional efficacy. The set of countries further shared similarities across a broad spectrum of variables that have traditionally been considered significant to determining the potential for economic development. The variance in population and territorial size when considered in a global or even European context is minimal, and no state is endowed with significant or exceptional natural resources. All three states are internally quite homogenous along ethnic, linguistic and religious ties, and have not fallen victim to fragmentation of identity politics. Finally, all emerged from communist rule through a negotiated and peaceful transfer of power between communist actors and opposition forces. The three states all implemented resilient parliamentary democracies with a goal toward the establishment of a free market regime and an orientation toward Europe. Building economic ties with the West with an eventual (reached) goal of joining the European Union served as the platform for all major political parties. Accordingly, public respondents across all three states listed Germany as the country they would most like to economically emulate (Katchanovski, 2000).

At the same time, there are important differences that provide the opportunity to discover variation. At the onset of the transition period, Czechoslovakia and Hungary adopted widely different approaches toward the founding of a market economy. Czechoslovakia implemented a system of shock therapy through widespread mass privatization and a focus on hard budget constraints. Slovakia largely abandoned this path with its independence in 1993, slowing the pace of reforms and halting mass privatization in favor of direct sales. Hungary, conversely, prioritized full liberalization of trade and exports, and continued to offer generous social programs, until an economic crisis in 1994 forced it to begin rapid privatization through direct sales to external investors and some cutbacks in public spending. Hungary failed to immediately adopt a program of economic reform or privatization, and permitted former elites to continue to manage and direct the state's economic and political institutions.

Data

In comparing the countries, this thesis draws on data from a number of sources. In addition to journal articles and books that have examined the development of Czech Republic, Slovakia and Hungary, I gathered economic data from the states' Statistical Offices, the World Bank, the International Monetary Fund, and the European Bank for Reconstruction and Development (EBRD). Unless otherwise specified, the data listed throughout the thesis has been sourced from the World Bank. The use of such varied data enables useful triangulation: rather than relying on single indicators or figures, this thesis draws on multiple sources to strengthen data accuracy and thus inference quality (Yin, 2013).

I avoided aggregate economic data based on cross-country surveys whenever possible in favor of raw economic indicators in order to minimize bias and imprecision. An exception to this rule is the use of the World Bank's Ease of Doing Business Report, based on the study of laws and regulations, with the input and verification from government, business and professional leaders in relevant countries. The Report has come under heavy criticism in the last two years for its relevance and robustness, and some experts have questioned whether the Report accurately measured the correct indicators (Economist, 2015). Some have questioned the subjectivity of the survey methodology, and the criteria that emphasizes weak labor regulations and low corporate tax rates as critical in determining a strong business environment. Indeed, the Report's research methodology has produced some dubious conclusions, such as ranking Zambia 12th in the world on access to credit for businesses, when according to International Trade Union data, over 90% of small businesses there cite this issue as a major constraint for their success. Still, the Report remains the only serious global effort to quantify and compare business conditions across various states. While the Report may therefore fail to give a precise picture of economic and entrepreneurial environments, it may prove some useful insight into particular problems, opportunities and policy efforts present in individual states.

The use of comparative raw data is impossible when examining issues of governance and institutions. Thereby, in looking at political or democratic variables, I used the Freedomhouse Freedom in the World Index. Although the methodology of the Index has at times been criticized as insufficiently sophisticated, the Freedomhouse Index nonetheless remains a standard in the field of political science (Merry and Davis, 2015). To analyze institutional stability and corruption, I used two widely known and respected indexes, the Heritage Foundation's Freedom from Corruption Index, and Transparency International's Corruption Index. Both indexes use their own research data to measure macroeconomic outcome variables for each individual country as well as qualitatively analyze the ability of the institutions to foster and sustain economic freedom. Certainly, an overall summary index of wide ranging variables may not adequately capture economic freedoms, and may be susceptible to subjective interpretations of existing policies. However, the indexes do illuminate legislative, institutional and political progress and processes, and where the conclusions between the different Indexes meet and synchronize, we can assume the presence of stated conditions and variables.

Data Analysis

The data were analyzed in several stages. First, the archival data were synthesized into comprehensive case histories for each country that captured its starting position; major changes; economic growth indicators ranging from fiscal indicators to trade and liberalization variables to entrepreneurial support measures; social welfare programs; political developments and institutional and administrative progress; and – perhaps most importantly – various economic policies implemented by individual countries over time. Next, across-case comparison allowed for the identification of patterns and differences between the countries. Using excel tables and charts, I listed tentative theoretical constructs that seemed to vary across cases. I compared these constructs to insights from prior literature in order to better understand their potential impact. By cycling between data and existing theory, I began to clarify the key constructs that appear to have led to different outcomes across the three countries. At this stage, I identified the potential importance of several factors, including the implementation of particular liberalization policies, the success and reach of privatization programs, and the creation of a particular kind of business environment.

In the third stage of analysis, I began to further unpack the potential impact of these processes. This involved returning to within-country analyses by gathering additional data on how each process unfolded within the countries over time, including evaluating stated policy objectives of various governments, and public perceptions of and support for such targets through results of parliamentary elections (that occur with high frequency due to large rates of political turnover in each of the three considered states). From this analysis, I was able to extrapolate not simply the presence of certain key variables or conditions critical to driving growth, but the processes that generated or cultivated them. Most notably, I was able to elucidate the relationship between the aforementioned factors and infer their causal direction. Of course, as I previously noted, these factors are to extent, necessarily cyclical and interdependent. However, in looking at the process of development in the Czech Republic, Slovakia, and Hungary, one pattern emerged: states that were able to effectively and efficiently privatize state-owned enterprises through broad programs that encouraged public participation in the new market system have been far better able to implement additional policies – ranging from support for key industries, to removal of subsidies, to hard budget constraints – necessary to further economic growth.

At the same time, I compared these emerging insights to existing research in order to strengthen the logical arguments about their relationship to growth. Sometimes, the literature suggested a potentially important factor I had not explored in my initial comparison; when this occurred, I searched the data for evidence of its explanatory power. Typically, I was able to dismiss these alternative explanations, as they did not bear out in the data. Thus, by iterating between within-case data, between-case comparison, and the literature, I began to develop a rich model of the processes that drove post-transitional growth. I concluded the analysis once I had developed a rich model that both captured the differences between the countries and the processes that fostered the divergence in their economic development, and what could account for potential alternative explanations suggested by prior theory.

CHAPTER 4: DATA AND CURRENT ECONOMIC INDICATORS

In 2005, the Czech Republic, Slovakia and Hungary were judged to have fulfilled the legal, institutional, political and economic conditions of EU membership, and acceded to the European Union. The economic and political strategies pursued by these states in the immediate aftermath of EU accession were largely a continuation of previously set economic agendas, determined in the first stages of transition from 1992 to 2000, that will be discussed at length in the following chapters of this thesis. Indeed, in terms of economic growth and a rise in living standards, the three states developed along a similar arc for much of the first fifteen years following their emergence from the Soviet bloc, although their economic policies, and economic, political and social priorities, diverged considerably. All three periodically suffered from declining or negative economic growth, yet these trends were short-lived, and GDP per capita, as well as convergence with EU living standards, rose steadily (Figure 4.1)

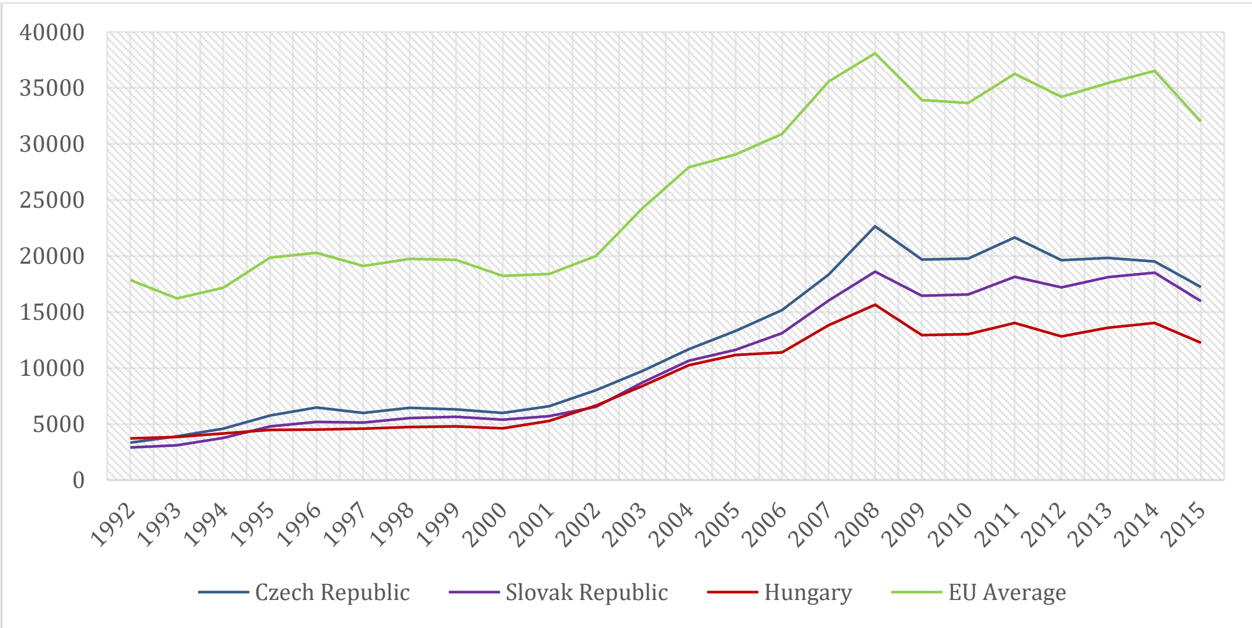
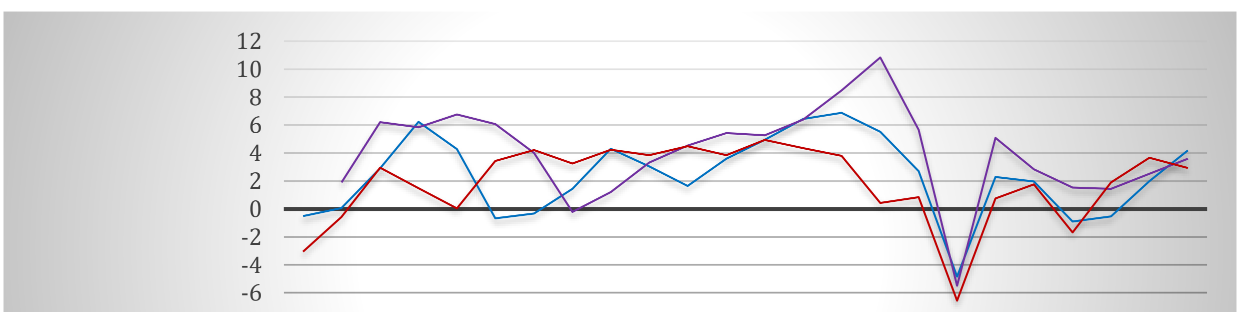


Figure 4.1: GDP Per Capita

However, as the global economic crisis progressed and reached Central Europe in late 2008 and 2009, it gave rise to a number of similar challenges across all states. The absence of credit, exchange rate volatility, and declining demand rapidly transferred the economic crisis from the financial sector to the rest of the economy throughout the region. Inflows of FDI, which had underpinned economic development models, dramatically decreased, and contractions in GDP affected labor markets, as employees' real wages were reduced and unemployment rose. Thus, new economic and political considerations; existing institutional, economic and social conditions; and available mechanisms created differing responses among the states. Some, like the Czech Republic and Slovakia, have been able to implement recovery policies that have led to sustained, if difficult, progress. Conversely, Hungary, which had generally mirrored and indeed surpassed its Central European neighbors in terms of transitional progress in the first two decades after the fall of communism, seems to have reversed its economic and political advancement. GDP per capita has fallen further behind its regional counterparts, as GDP growth between 2008 and 2015 has averaged 0.35%, well below the average GDP growth rates of the Czech Republic (1.1%) and Slovakia (2.2%).



	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15
Czech Republic	-1	0.1	2.9	6.2	4.3	-1	-0	1.4	4.3	3.1	1.6	3.6	4.9	6.4	6.9	5.5	2.7	-5	2.3	2	-1	-1	2	4.2
Slovak Republic		1.9	6.2	5.8	6.8	6.1	4	-0	1.2	3.3	4.5	5.4	5.3	6.4	8.5	11	5.7	-5	5.1	2.8	1.5	1.4	2.5	3.6
Hungary	-3	-1	2.9	1.5	0	3.4	4.2	3.2	4.2	3.8	4.5	3.8	4.9	4.4	3.8	0.4	0.8	-7	0.7	1.8	-2	1.9	3.7	2.9

Figure 4.2: GDP annual growth

An analysis of the economic development patterns evident in data of these Central European states reveals – perhaps unsurprisingly – that the Czech Republic and Slovakia, which entered the economic crisis in 2009 with a sound banking and financial regime, supported by generally balanced public budgets, have been able to spur recovery even in the face of ongoing domestic obstacles and sluggish regional growth. The initial drop in GDP growth was smaller, and its recovery faster than in Hungary. The three factors that have been critical to generating sustainable and stable growth, and tempering the length and effects of the 2009 recession, have been low inflation rates, sound state spending and debt ratios, and a strong, well-regulated banking sector. Across the indicators, Hungary posted the worst performance since 2008, with the exception of Gross National Expenditure, which continues to be highest in Slovakia. The Czech Republic outperformed its neighbors on all metrics. Data and figures for these indicators can be found at the end of the chapter (Figure 4.3 through Figure 4.6); they will be discussed at greater length in Chapter 5 for the first transition period.

Indeed, the experiences of the Czech Republic, Slovakia and Hungary over the past twenty years appear to reaffirm the "Washington Consensus" conditions of development emphasized by economists in the first half of the 1990s. Yet a mere recognition of the importance of these three factors does little to reveal why some states were able to follow advised economic guidelines. All three states examined in this thesis have faced economic issues directly caused by shortcomings in government regulations or errors of government policies. They have likewise faced challenges in the social and welfare sectors, with varying degrees of success in addressing such concerns.

This chapter will provide data to illuminate the current and projected economic conditions in the Czech Republic, Slovakia and Hungary. It will particularly highlight the active drivers and, conversely, suppressors of economic growth, and the circumstances that have encouraged them. Chapters five though seven will subsequently provide a historical analysis of how these conditions stem from initial privatization and liberalization schemes, and the economic policies that followed first transition efforts.

Overview of current economic and political conditions

Two decades after the collapse of communist regimes, there is a wide range of political, economic and social systems in the region, with the post-communist countries of Central and Eastern Europe (CEE) following two distinct trajectories. Advanced democratic welfare states such as the Czech Republic and Slovakia have achieved substantial political, economic and social convergence with standards of the continental EU states. For ten years before the 2008 crisis, the Czech Republic enjoyed the longest period of uninterrupted growth in its history, and was praised for its success in attracting foreign direct investment, and for its favorable labor-market outturns. Following the Velvet Revolution, Czech governments set a program of rapid privatization, economic liberalization, and budget constraints. Inflation and debt targets were vigorously defended, and public spending was cut on various occasions, most notably after the 1997 and 2008 crises (Figure 4.4). Inflation has been the lowest in the region since 1998 (Figure 4.3), and debt to GDP ratio since 1995 (Figure 4.5). The Czech Republic suffered an economic crisis in 1997 due to a collapse of its banking regime, but the financial system subsequently rebuilt a conservative balance sheet structure marked by a high levels of capital and liquidity, and a high share of loans denominated in local currency. It has hence withstood the turmoil of the global financial crisis, without exceptional state interventions or external assistance. The Czech Republic has been able to recover from the economic crisis, and currently enjoys positive growth prospects for the short and medium term outlook (IMF, 2013).

Slovakia, too, has long enjoyed a favorable competitive position through a range of connections to international financial markets, relatively high corporate profitability and high productivity growth. In 1993, the newly independent state rejected much of the Czech economic model in favor of retaining a socialist safety net. Gross national expenditure exploded between 1994 and 1999 (Figure 4.4), and high rates of government spending still present the greatest challenge to the overall health and stability of the economy. However, an economic downturn in the mid-1990s shifted the economic agenda back toward macroeconomic stabilization and market-oriented structural reforms. Prior to the financial crisis, the profit growth of the non-financial business sector in Slovakia was the highest in Eastern Europe, and far exceeded most developed Western European states. Throughout much of the following decade, Slovakia posted among the highest GDP growth rates, reaching well above 6%, in the OECD (Figure 4.2). From 2009 to 2013, Slovakia’s economy had experienced one of the strongest post crisis recoveries in the EU. Although Slovakia’s recovery has recently proved more problematic, it continues to display positive growth.

Hungary initially appeared to follow this course; however, its inability to recover from the 2008 financial crisis, and its recent turn toward illiberal democracy has undermined the progress made in the years following the transition. In early transition, the state economy contracted significantly, and recovered more slowly than its regional counterparts (Figure 4.2). Nevertheless, as a new government introduced a package of economic reforms in 1995, investor confidence rose sharply and Hungary made full use of its geographical and historical ties to Western Europe to dramatically raise exports and trade links. Hungary entered a period of stable and continued growth from 1995 to 2008, and inflation and GNE were both notably reduced (Figures 4.3 and 4.4), suppressing levels of public debt (Figure 4.5). Nevertheless, this fiscal discipline did not enjoy much popular support among the Hungarian population. Since 2001, Hungary has maintained an exceptionally high level of public debt and public spending, that had previously been financed principally through privatization of state owned enterprises to foreign owners, and successive governments pushed back against austerity constraints. However, declining exports, reduced domestic consumption, a growing deficit, and fixed asset accumulation led to a deep financial crisis of 2008, as growth declined by almost 7%.

The parliamentary elections of 2010 marked a pivotal shift in the Hungarian political system. The right-wing Fidesz-party under the leadership of Victor Orbán attained a landslide victory, and has dominated Hungarian public life and discourse ever since. Immediately following the Fidesz victory, Orbán embarked on radical changes in Hungarian politics that have affected the country's economic prospects, and have threatened to destabilize Hungary's democratic institutions. Under the auspices of ousting former socialist officials and strengthening conservative forces within the Hungarian civil service and media, Fidesz moved to enhance and consolidate the party's command over public structures. The Fidesz government has pursued a program of state driven economic-populism that has introduced cuts in income taxes and utility prices while attempting to curb the fiscal deficit through a system of nationalizations, sweeping and high sectorial taxes, and selective awards of government contracts that have increased government control over the economy. Although deficit has indeed fallen, debt has stayed well above 75% of the GDP.

Orbán's "unorthodox" ad-hoc austerity measures have proven to be deeply suspicious of private enterprise, foreign capital, and opposition and minority groups: various "crisis taxes" have been levied on sectors with large foreign participation, including banks, telecommunications, media and energy companies; private pension funds have been effectively nationalized. In 2014, the government announced a 40% tax on ad revenues that seems to particularly target the country's only major independent television network, which could result in its bankruptcy, and has publicly considered the idea of the world's first tax on internet usage. Consequently, in September 2014, former United States President Bill Clinton proclaimed Orbán's regime to be one of "authoritarian capitalism." The European Commission is currently investigating a number of Hungarian policies believed to be incompatible with EU law, including a failure to modify laws relating to the independence of the Central Bank. Although Hungary's external relationships remained stable and cordial, albeit strained, during Fidesz's first mandate, recent political developments have may have well jeopardized Hungary's Western alliances. As Prime Minister Orbán has grown more critical of the European Union, international financial institutions, and the United States, he has begun to increasingly court favor in Russia. In July 2014, Orbán proclaimed that Hungary "will undertake the odium of expressing that in character it is not of liberal nature." Citing as models Singapore, China, India, and Russia, he added, "We have to abandon liberal methods and principles of organizing a society, as well as the liberal way to look at the world" (Waller, 2015).

Data on economic development in the Czech Republic, Slovakia, and Hungary

Czech Republic

Despite remarkable success of the Czech economy in the last 15 years, in the first stages of transition, compared to some other central and eastern European countries, convergence of the Czech economy to the EU-15 was somewhat slower. Moreover, after growth fell by 4.5% in 2009, the economy has faced a lengthier recovery than some of its neighbors; modest growth achieved in the immediate aftermath of the economic crisis was reversed in 2012 and 2013, as the economy contracted by 1% and 0.9%, respectively. Nevertheless, the Czech Republic posted growth of 4.2% in 2015, according to the World Bank (Figure 4.2). Between 2014 and 2016, the Czech Republic is expected to outperform the OECD average in terms of low inflation, unemployment and deficit. The recovery is becoming more balanced as supportive financial conditions, government spending, rising confidence and stronger incomes are bolstering domestic demand (Figure 10). Although household consumption stagnated last year, recent retail sales data and strengthening confidence indicators point to rising household consumption growth that should be supported by rising real wages, low inflation, and an improving employment outlook. The risks to Czech economic prospects are therefore relatively limited.

The growth model of the Czech economy had been one of rapid accumulation of production factors, especially capital, and of strong export orientation (Figure 4.7). The build-up of fixed capital was supported by high inflows of foreign capital, attracted by cheap but relatively skilled labor, and the proximity to the economic core of the EU (Figure 4.8). However, the success of Czech external liberalization policies during the transitional period, and the state's integration into the European manufacturing supply chains left the economy particularly vulnerable to external shocks.

4.1 Czech Trade Averages	1993-1999	2000-2004	2005-2007	2008-2012	2015
Exports annual change	0.02%	15.9%	14.51%	4.50%	7.70%
Imports annual change	0.02%	16.3%	12.38%	3.29%	8.22%
FDI Inflow, % GDP	3.91	6.62	5.9	3.52	1.34

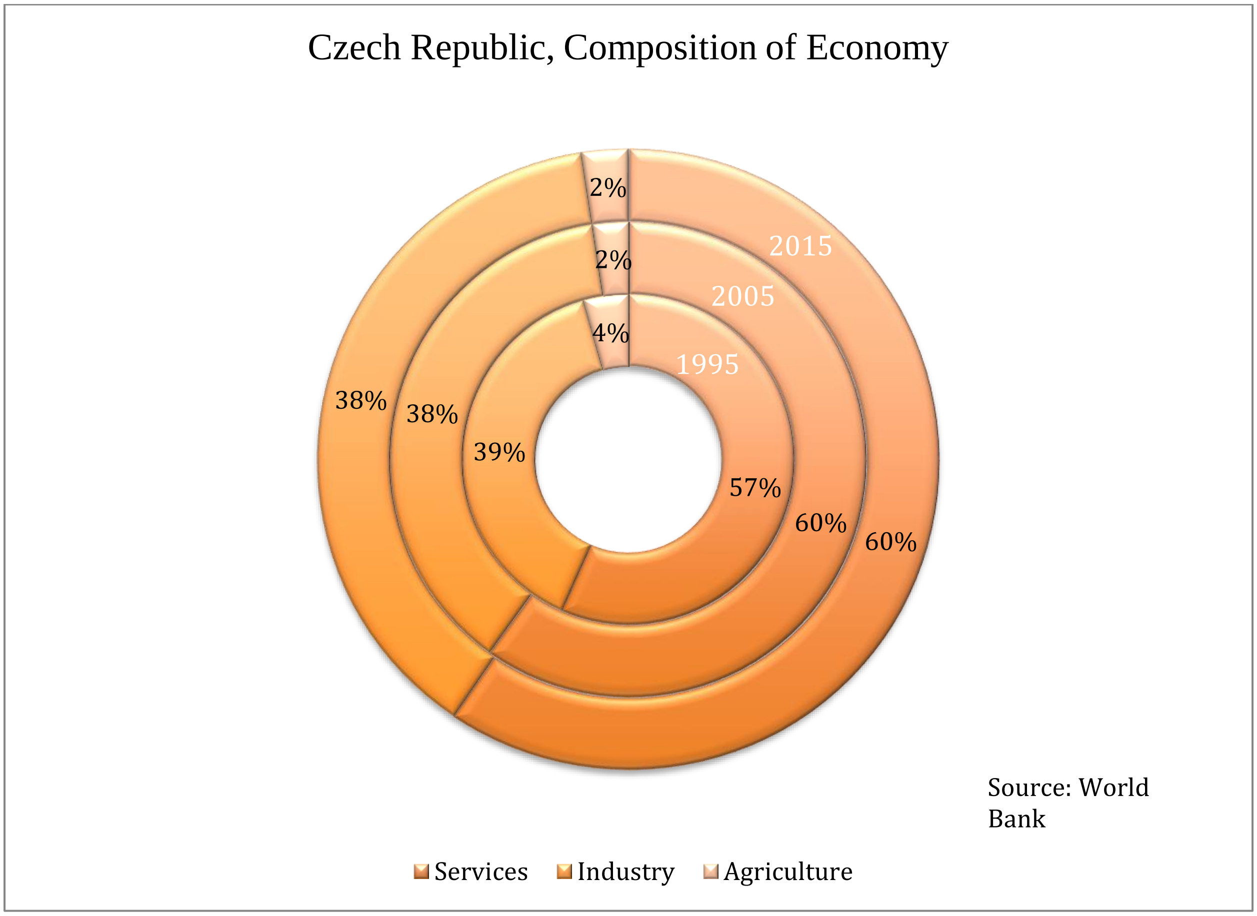
In 2009, exports fell by more than 10.8%, and FDI shrunk to 1.4% of the GDP, with a particular reduction of inflows to the manufacturing sector. Correspondingly, the recently improved global economy has spurred and sustain Czech economic recovery, as exports and FDI began to rise in 2010. The nominal exchange rate has varied since 2002, but proved stable during the financial crisis. The Czech koruna depreciated in 2009 and again between 2011 and 2014 in order to promote export growth. Imports have risen somewhat more slowly since 2009. The European Union continues to be main Czech trading partner, but trade with Southeast Asia, chiefly imports from China, has recently been on the rise. Export-oriented sectors, notably the manufacturing industry, were the main drivers of growth in 2014. Rebalancing of domestic drivers and amplified confidence in both the corporate and household sectors followed in 2015.

The Czech Republic’s weak economic performance after global economic downturn left its mark on the country’s once very solid fiscal position, as public debt increased from 29% of GDP in 2008 to 46% of GDP in 2014.

4.2 Czech Republic Public Finances	1993-1999	2000-2004	2005-2007	2008-2012	2015
Surplus/Deficit	-1.22	-3.99	-2.9	-3.63	-0.4
Debt	11.9	15.69	22.29	32.95	42.5
Inflation	10.01	2.67	2.43	2.81	0.34

Fiscal loosening in the years prior to the economic crisis was reversed through austerity policies in 2010. The government introduced structural consolidation measures equal to 4.2% of GDP between 2010 and 2012 in order to strengthen the underlying fiscal position, and avoid greater public debt levels, which are expected to stabilize at approximately 47% of the GDP by 2016. The Czech government additionally introduced a structural balance rule that aimed to limit the deficit to 1% of the GDP, and a debt brake complete with a range of automatic budget procedures to be initiated in the event the debt exceeds 55% of the GDP. Following a budget deficit of 5.9% of GDP in 2010, which was partly due to one-off expenses related to Church compensation payments and withheld EU funds, the Czech deficit fell to 0.4% of the GDP in 2015, surpassing the 2.8% target set forth by the European Union. At the same time, the structural budget deficit improved from 3.1% to 2.4% of GDP.

The private sector in the Czech Republic has managed to successfully rebound following the 2009 crisis. Both services and industry contracted in 2009, but have grown in the past two years. The Czech economy relies principally on the service sector, yet manufacturing continues to comprise a significant, and profitable, segment of the economy.



Industrial production, which fell by 13.9% in 2009, and by 0.8% in 2012, was expected to grow by more than 4% in both 2014 and 2015, and retail sales are similarly on the rise. According to the OECD, corporate profits, which had been increasing steadily prior to the crisis, have recovered since plummeting in 2009, and reached a record high in 2013. The EBRD has reported that business confidence, which in 2009 fell to approximately to 72%, and again in 2013 to 83%, has steadily climbed since 2013 to approximately 93% in 2014. Likewise, consumer confidence – defined as the expected financial situation of consumers, expected total economic situation, expected total unemployment and expected in the upcoming 12 months – which had been negative since 2008, finally climbed to 2% in 2014.

4.3 Czech Republic Business Indicators	1993-1999	2000-2004	2005-2007	2008-2012	2015
Labor Productivity, change	2.4	4.69	5.05	0.45	4.3
Industrial Production	1.5	5.62	7.6	-0.34	4.6
Corporate Profits, change		6139	27.69	2.51	4.76
Business Confidence	84.93	98.88	102.7	88.98	94

Labor productivity rose by an astonishing 4.3% in 2015, recovering much of the growth levels posted prior to the crisis. Further productivity growth is delayed by a number of entwined questions, ranging from low investment in scientific research, to an overly byzantine regulatory framework that diminishes competition in services and sets excessive compliance costs for businesses, and inadequate infrastructure – though it should be noted such challenges persist across the region. In 2013, the government adopted two plans to address transport infrastructure issues, but the proposed measures are not expected to be set in place nor yield results in the immediate term.

Fiscal consolidation in the Czech Republic was evenly distributed between expenditure and revenue measures (IMF, 2013). Higher-than-projected revenue was recorded in taxes on production, social contributions, and in property income, reflecting the strong performance of some state-controlled companies. Of the revenue measures, almost half consisted of changes in the VAT system rather than taxes on income or labor. Before 2009, the Czech VAT had a relatively low rate, accounting for some 6.2% of GDP, or 17% of tax revenues (Figure 4.13). Since the financial crisis, the VAT system has been broadly and successively altered as part of a strategy to increase the portion of indirect taxes in total tax revenue. The standard VAT rate was raised from 19% to 21%, and the reduced VAT rate from 9% to 15% (Figure 4.12). While these modifications hoped to achieve an immediate increase in tax collection in the short term, the 2016 unification of the VAT rate of 17.5% is projected to be revenue neutral.

By 2013, the Czech Republic had posted a fall in public investment of 12%, and had achieved savings in interest expenditure and in social transfers. This drastic reduction of government investment has gone against EU recommendations to prioritize growth-enhancing expenditure, and has raised concerns about the Czech growth potential. However, investment surged by almost 30% in 2014, principally due to an increase in EU-funded projects. The government has likewise pledged increased investment, chiefly in infrastructure projects. Still, dedication to deficit reduction suppressed domestic investment rates to 1% growth in 2014, well below the EU counsel of 3%. Yet, both private and government consumption, which had decreased in 2012 and 2013, finally began to rise in 2014.

4.4 Czech Republic	1993-1999	2000-2004	2005-2006	2008-2012	2015
Consumer Confidence	71.68	89.91	101.36	84.96	104.86
Household Expenditure, change	1.8	3.2	4.56	0.52	2.99

The escalation in consumption should drive up the extremely low inflation to approximately 1.9% between 2015 and 2019. Accordingly, by 2016, monetary policy focused on restraining inflation is expected to permit the exchange rate to float freely.

The financial system in the Czech Republic drew lessons from the 1997, domestically driven crisis. High levels of capitalization and prudent lending practices were introduced as a hallmark of the industry. The banking sector remains well-capitalized, with a comparatively high average return on assets; a stress tests conducted by the Czech National Bank in 2013 confirmed the resilience of the Czech banking sector against deterioration of the real economy and external risks (CNB, 2016). In 2015, the share of non-performing loans in Czech banks amounted to 5.3%, the capital adequacy ratio was well above 17%, and the return on equity reached almost 18%, the second highest in the EU (EBRD, 2016).

4.5 Czech Banking Sector	1995-1999	2000-2004	2005-2007	2008 - 2012	2013	2015
Share Foreign Currency Denominated Loans			21	21	16	
Systemic risk due to FX loans					3.50%	
Share Non performing Loans	21.03	12	3.3	4.6		5.47
Capital Adequacy Ratio	14.2	14.74	11.4	14.3		17.5
Domestic Credit from Banks, % GDP	60.81	30.66	34.2	46.8		51
Domestic credit to Private Sector as share of GDP	62.43	31.39	34.17	46.82		50.3

In order to stimulate investment and consumption, the Czech benchmark interest rate was considerably reduced following the 2008 crisis, and has been at a historic low of 0.05% since late 2012. Domestic credit from the banking sector reached 51% in 2015, and bank loans to the private sector grew by 3.8% in 2013. Nevertheless, the loans-to-deposit ratio of equal to some 73% of the GDP suggests that the credit supply is unlikely to be considered a major factor in access to financing.

Slovakia

Prior to 2013, Slovakia's economy had experienced one of the strongest post crisis recoveries in the EU. Although the GDP fell by 4.9% in 2009, Slovakia has consistently posted GDP growth in ensuing years (Figure 4.1). However, stagnating domestic demand and deceleration of exports slowed GDP growth to a mere 0.9% in 2013 (Figure 4.2). Growth increased modestly to 2.5% of the GDP, and is forecast to remain at 2.5% in 2015. The GDP is projected to grow by 3.3% in 2016 as a result of increased domestic demand, the primary driver of growth in 2014, and expanding investment. Household consumption strengthened to 2.8% in 2014 after half a decade of weak or negative growth due to low inflation; rising wages; and an end to fiscal austerity measures.

4.6 Slovakia	1993-1999	2000-2004	2005-2006	2008-2012	2015
Consumer Confidence	-22.26	-31.13	-7.84	-25.4	-11.85
Household Expenditure, change	5.29	4.58	7.54	0.9	1.86

Construction activity is also beginning to experience a revival, signaling improved prospects for fixed investment after declines in 2012 and 2013; gross fixed capital formation grew by 4.1% in 2014 due to the expansion of investment in equipment and residential and non-residential construction, and further growth is expected in 2015 and 2016. Confidence indicators thus showed strong gains in 2014, with an especially sharp increase in construction and consumer sentiment.

By contrast, exports, which rose by 4.4% in 2014, continued the trend decelerating growth since 2010, mainly because of slow GDP growth in Slovakia’s main trading partners (Figure 4.7). Slovakia’s extremely open economy and poor diversification of the export sector, where cars accounted for 20% of all exports in 2011 and 41% in 2013, have left it highly susceptible to external demand shocks. Revealingly, exports contracted by 15.9% at the height of the financial crisis in 2009. Imports grew faster than exports in 2014, a development that continued through 2015, but the trade in both should equalize in subsequent years, and the current account balance is expected to remain positive through 2019. Foreign direct investment has similarly failed to return to pre-crisis levels; after falling to 1.8% of the GDP in 2009, it has grew temperately to 2.2% of the GDP in 2013 (Figure 4.8).

4.7 Slovakia Export Averages	1993-1999	2000-2004	2005-2007	2008-2012	2015

Exports, annual growth	-0.04	16.1	16.8	4.66	7
Imports, annual growth	-0.04	15.22	14.77	2.34	8.12
FDI Inflow	1.2	6.73	6.73	3.23	1.32

As a member of the Eurozone, Slovakia has been unable to devalue its currency in order to catalyze exports and investment.

The relatively weak recent performance of the export sector and foreign investment have exerted negative pressure on the Slovak economy. Slovakia had suffered from continually high budget deficits since the pre-crisis period of high economic growth, and has struggled with significantly reducing the deficit since 2008, when it reached 8% of the GDP. The deficit finally fell in 2013 with rising tax revenues and the introduction of new austerity budgetary measures, consolidation packages including sales of emergency fuel stock, and pension reforms.

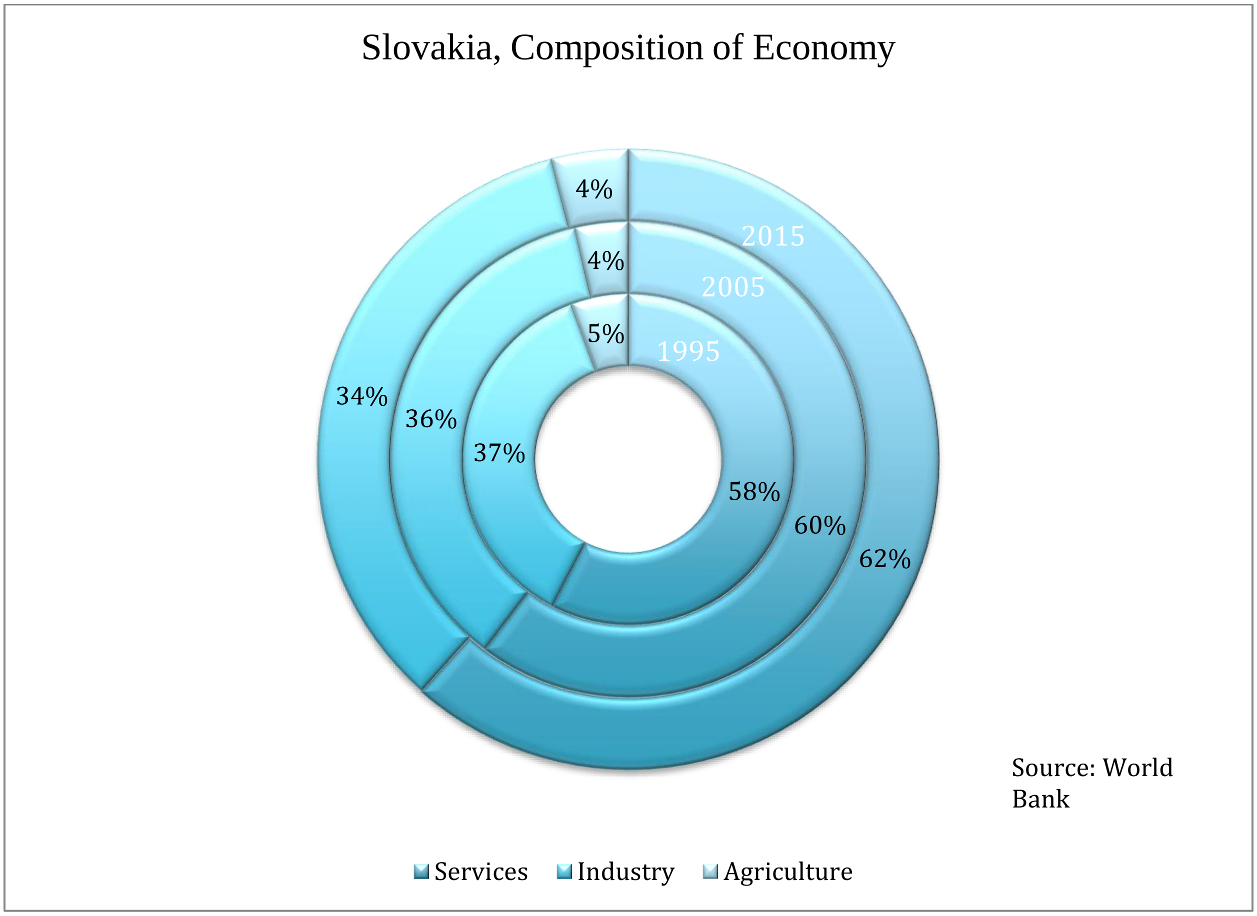
4.8 Slovakia Public Finances	**1993-1999**	**2000-2004**	**2005-2007**	**2008-2012**	**2015**
Deficit	-2.16	-2.33	-4.16	-5.72	-2.97
Debt	6.66	18.58	33.3	42.44	42.5
Inflation	10.82	7.76	3.32	2.94	-0.33

The deficit rose to 3% of the GDP in 2015 despite a freeze on government spending, but is projected to decline, principally as a consequence of tax-rich growth. The structural budget deficit fell from 4.1% of GDP in 2012 to 3% in 2013 and 2.4% in 2014, and is set to improve again in 2015 and 2016.

Assuming substantial draw-downs of the cash reserves in 2014, and use of the expected privatization proceeds for debt reduction in 2015, general government debt, has remained relatively low in comparison to regional averages throughout the crisis period. Therefore, the European Union recently announced that the long-term sustainability of Slovak public finances has improved, and Slovakia does not appear to face a risk of fiscal stress in the short term.

Slovakia was released from the European Commission's Excessive Deficit Procedure in 2014 (EU Commission, 2013). Nonetheless, the country is considered to be at a moderate sustainability risk in the medium-term and long-term perspective, conditional upon full implementation of the ambitious planned fiscal consolidation, and upon preservation of the primary balance well beyond 2014. Temporary or special measures that have recently been reduced to improve public finances will need to be progressively replaced with structural reform, particularly in the areas of pension and social expenditures.

Slovakia has long enjoyed a favorable competitive position through a range of connections to international financial markets, relatively high corporate profitability and high productivity growth. Prior to the financial crisis, the profit growth of the non-financial business sector in Slovakia was the highest in Eastern Europe, and far exceeded most developed Western European states. The relatively positive macroeconomic outlook since the crisis has allowed for high creation of new enterprises: new business density reached 5.11 per 1000 working-age individuals in 2012, suggesting a healthy emerging entrepreneurial atmosphere. The development, expansion and refinement of manufacturing clusters should further advance Slovakia's business environment, international investment inflows, and economy.



The country's industrial base is, however, specialized in a few capital-intensive, cyclically sensitive sectors (EU Commission, 2013). In 2012, manufacturing comprised 26% of total value added to the Slovak economy, compared to the EU average of 15.5 %, and machinery and transport equipment together accounted for 54% of export products in 2011. Thus, industrial production in Slovakia has been extremely volatile since the start of the financial crisis, dropping by 15.4% in 2009, and growing by 8% the following year. Growth of the industrial sector has stagnated and decelerated in the last four years, although production grew by 7% in 2015, driven almost entirely by record investments in and outputs from the automotive sector.

4.9 Slovakia Business Indicators	1993-1999	2000-2004	2005-2007	2008-2012	2015
Labor Productivity, change	4.7	4.92	5.63	1.62	2.1

Industrial Production	2.4	6.84	8.63	2.14	7
Business Confidence	1.26	6.12	8.11	-3.46	1.8

Consequently, business confidence in Slovakia, which was eroded with the financial crisis, continues to struggle despite economic growth, and currently stands at under 10%.

Slovak labor productivity has grown at over 2% since 2010, and is predicted to rise by 2.8% in 2016, with the most notable increase stemming from the manufacturing industry. Technology imports presented a major source of productivity improvements; turnover from innovation or products new to enterprises and the market as a ratio of total turnover in 2010 measured at 23.4%, well above the EU 27 average of 13.4%. Innovation turnover was particularly high in the industrial sector. As productivity remains higher, and wages – though rising – lower than the Eurozone average, Slovakia will continue to be attractive to foreign business and investment. In the long term, however, labor costs, technological capability and productivity should converge with EU standards, and Slovakia will have to catalyze private sector and productivity growth through business innovation, a consistent and fair corporate environment, and targeted investment.

With the improved economic picture, government consumption, which had been negative between 2010 and 2012, has began to grow. Concurrently, however, following a spike in 2011, government investment has dropped. The European Union has projected a decline in the Slovak public investment ratio from 1.9 % of GDP in 2012 to 0.6% of GDP in 2016, a very low level for an economy in recovery. Supplementary cuts in capital expenditure would be harmful to Slovakia's infrastructure, undermining the economy's long-term growth projections (EU Commission, 2013). An initial planned increase in expenditure on research, development and innovation announced in 2013 is to be followed with a decline in public spending. Given the need to support continuing economic convergence through spending in key areas such as education, innovation and transport infrastructure, a key challenge for Slovakia will be to acquire additional resources by broadening the tax base; increasing revenue through taxes that are less detrimental to growth; and limiting the scope for tax fraud and evasion.

To maintain a fiscal balance, the Slovak government has introduced a variety of tax measures designed to increase revenues. In 2013, the government raised the personal income tax rate for highest earning individuals from a flat rate of 19% to 25% (Figure 4.12). In 2012, it passed measures that shrunk the vast differences in taxation among different types of employment, and abridged the rules on social contributions. Nevertheless, no review was carried out to evaluate deductibility rules that remain an important drawback of the taxation system for self-employed persons, as their declared costs for tax purposes constitute 80-90% of the declared revenue. Thus while the self-employed represented 15% of total employment in 2012, they generated less than 6% of the overall personal income tax collected. In 2012, the government furthermore approved a three-phase action plan with precise measures and implementation timelines to fight tax fraud, with a particular focus on VAT. No tangible impact has been observed so far, as VAT collection subsequently dropped by some 10% in cash terms.

In 2012, the Slovak government also enacted a 0.4% tax on corporate and retail deposits to finance a fund that can cover the costs of a possible bank bail-out. The tax rate is set to be halved when the fund has raised 500 million Euros, and abolished as it reaches 1 million Euros. Yet despite this cautionary state measure, the Slovak banking system proved robust during the crisis and has remained strong. The stability of the banking sector is expected to continue to be supported by healthy, profitability, high deposit-to-loan ratios, and a negligible share of loans in foreign currencies. In 2015, the share of non-performing loans was under 5%, the capital adequacy ratio had risen to 16.8%, and the return on equity had fallen slightly to 11.2%.

4.10 Slovakia Banking Sector	**1995-1999**	**2000-2004**	**2005-2007**	**2008-2012**	**2013**	**2015**
Share Foreign Currency Denominated Loans			21	8.4	1.5	
Systemic risk due to FX loans					1.10%	
Share Non performing Loans	27.5	8	3.6	4.9		4.87
Capital Adequacy Ratio	10.57	18.9	13.67	13.1	17.2	16.8
Domestic Credit from Banks, % GDP	47.61	36.6	34.67	44.6		53
Domestic credit to Private Sector as share of GDP	55.44	37.39	35.2	44.81		53.46

Nonetheless, despite the overall resilience of the sector, ease of access to financing was negatively affected in 2012 by both the cyclical downturn and an increase in credit risk. While the number of loans to non-financial, private firms increased at a moderate pace from 2010 to 2011, in 2012 it declined by 3.6%. Bank loans to the private sector have increased steadily in the past two years, reaching their highest value in 2016, and nearly doubling since 2006.

Hungary

Although Hungary had been one of Eastern and Central Europe's top economic performers in its first two decades of independence, its economic prospects quickly unraveled with the global financial crisis. In addition to external pressures that depressed exports and investment across the region, in 2008 and 2009, Hungary entered the crisis with large deficits on both the current and fiscal account (Figure 4.6), and an overleveraged private sector burdened by massive mortgages held in foreign currencies. In 2008, the IMF, the EU and the World Bank contributed a 20 billion Euro stabilization package to Hungary contingent on a variety of conventional austerity measures designed to curb public spending and deficit. However, both this program, and the reactive, unorthodox domestic crisis measures, publicly dubbed “Orbánomics,” deployed by Hungary’s controversial Prime Minister, Victor Orbán, since 2010 appear to have largely failed to stimulate recovery and correct the structural imbalances in the state’s economy. The economy contracted by almost 7% in 2009, and grew by a mere 1.1% in 2010 before falling back into recession at the start of 2012 (Figure 4.2). Growth in incomes has lagged behind the rest of Central and Eastern Europe: in 2005, Hungary’s gross domestic product per capita trailed only Czech Republic and Slovenia in Central and Eastern Europe; by 2013, it stood above only Romania and Bulgaria (Figure 4.1). Convergence with EU living standards has stood unchanged since 2009, at only 66% of the EU average. GDP growth was faster in 2014, at 3.3%, and is predicted to reach 1.7% in 2016, according to the OECD, indicating that the economy may be entering a period of stabilization, if not outright revival.

Nevertheless, deep-rooted structural weaknesses in the economy have expanded over the last five years, and will likely undermine the possibility of strong economic development in the foreseeable term. In 2012, the European Union hence instigated a Macroeconomic Imbalance Procedure for Hungary in an attempt to identify and reverse possible economic risks. Across indicators, Hungary’s economic deterioration was pronouncedly higher than in the Czech Republic and Slovakia, while recovery has been more sluggish and fickle.

Moreover, many of the general economic indicators belie Hungary's economic weakness. The bump in economic growth in 2014, which exceeded previous expectations, can be attributed principally to a stronger domestic demand, and, to a smaller extent, an augmentation of exports. Private and public investment rose, after posting negative growth in 2012, and domestic demand will endure as the key engine of economic growth, although investments will be spurred in favor of private consumption.

4.11 Hungary	1993-1999	2000-2004	2005-2006	2008-2012	2015
Consumer Confidence	-25.7	-22.09	-37.39	-47.09	-14.88
Household Expenditure, change	1.12	5.27	2.34	-2.29	3

However, the surge in investment in the first half of 2014 was in part catalyzed by one-off factors, such as enhanced absorption of EU funds, and subsidized loans to SMEs from the Central Bank's Funding for Growth Scheme; by the last quarter of 2014, growth was decelerating (EU Commission, 2014). Household consumption fell more drastically than in the region following the economic crisis, and has been slower to recover.

Indeed, future potential growth is capped at 2% as the economy relies heavily on public spending – government consumption and expenditure (Figure 4.4) remain among the highest in Europe, exceeding 20% and 47% of GDP, respectively. Debt levels, which damaged the economy prior to 2008 have continued to rise and impede recovery at approximately 78% of the GDP (Figure 4.5); external debt, while falling since 2010, continues to exceed 100% of the GDP. Inflation, which had stayed between 4% and 5% during and immediately following the financial crisis, fell drastically by 2015, partly due to cuts in regulated utilities and energy prices. Inflation should rise in 2016, but remain at low levels.

4.12 Hungary Public Finances	1993-1999	2000-2004	2005-2007	2008-2012	2015
Deficit	-8.38	-7.5	-8.69	-4.88	-1.9
Debt	75.74	60.46	67.71	84.09	78
Inflation	19.37	7.13	5.12	4.95	-0.07

The debt-to-GDP ratio is forecast to decrease slightly in the short term as the negative impact of the weakening exchange rate and corporate takeovers is expected to be largely offset by additional stock-flow operations and residual funds for EU projects. Should financing conditions deteriorate due to a negative shock to the external environment or domestic confidence, this recent positive trend is likely to be reversed.

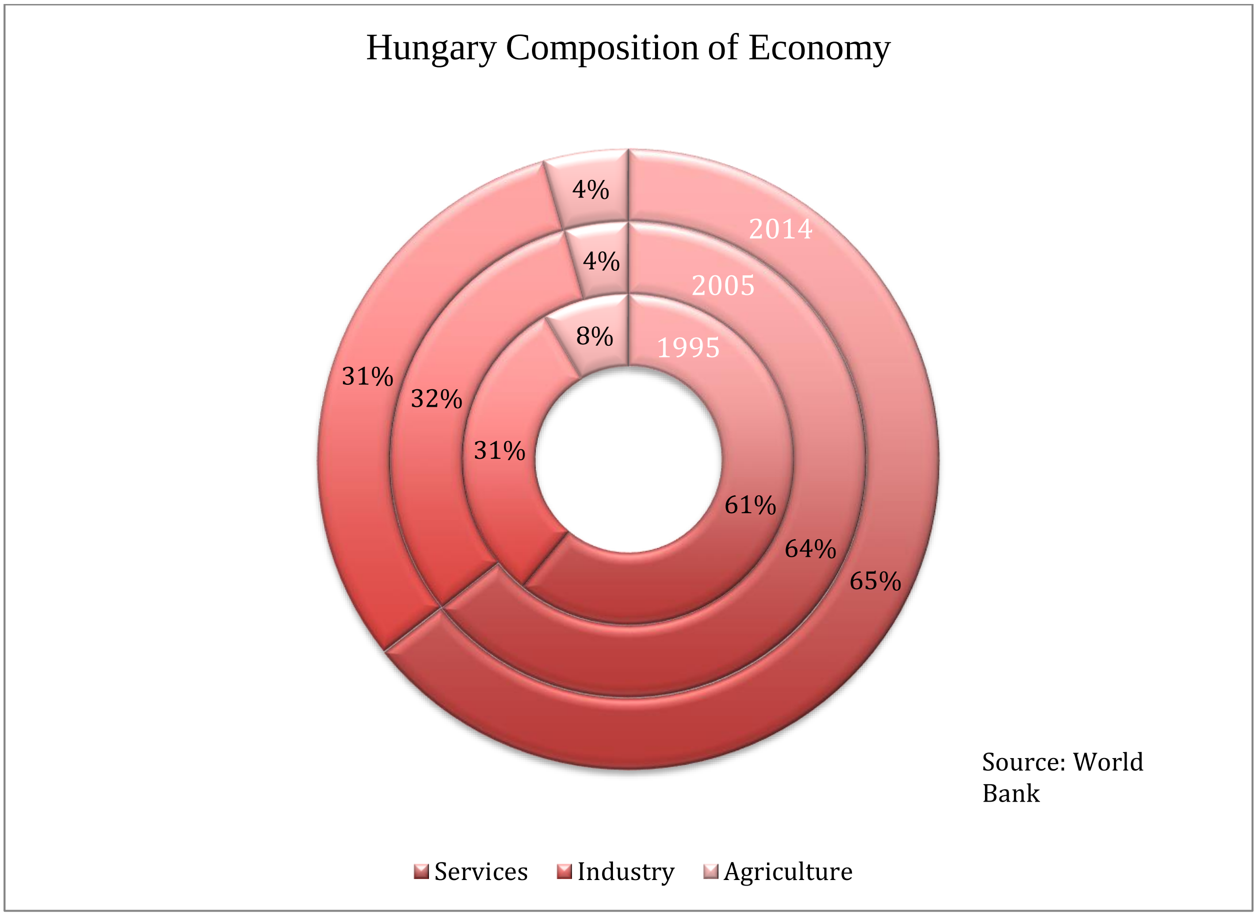
Conversely, export growth is forecast to decrease slightly due to weaker demand from major trade partners, poor spillover linkages between multinational and domestic corporations, and an inability to attract new sources of foreign investment. Hungary had been the regional leader in share of exports to the GDP; since the crisis, exports have grown faster in both the Czech Republic and Slovakia. FDI inflows, which had been extraordinarily high in the early 2000s, have fallen since a post-crisis high of 11% of the GDP in 2011, to 3.6% in 2014, and an estimated 3.3% in 2015. The temporary swell in 2011 was attributed chiefly to financial flows from foreign banks re-capitalizing their Hungarian units, and a large-scale investment in the automotive industry that did not substantially strengthen the export sector.

4.13 Hungary Export Averages	1993-1999	2000-2004	2005-2007	2008-2012	2015
Exports, annual change	-0.34	15.92	16.17	2.31	7.7
Imports, annual change	0.11	16.1	12.42	0.48	6.1
FDI Inflow	6.91	5.61	24.06	9.04	-2.16

A weak external growth potential has been further exacerbated by a worsening business environment, driven by a lack of economic predictability and distortive effects of government policies. Outside investors remain wary of Hungary.

With a reversal of IMF mandated austerity measures, the Hungarian government pursued a policy of fiscal loosening in 2010 and 2011, with an accompanying reduction in deficit, according to the European Union (Figure 4.6). [Some data sources include revenues from the mandatory nationalization of private pension funds in 2010, giving Hungary a surplus of over 4% of GDP in 2011, although this does not reflect EU accounting practices.] In 2012, and again in 2013, the government initiated a consolidation agenda, and the deficit is projected to remain below EU's 3% target, thus improving Hungary's budgetary position. The structural balance, which had considerably improved in 2012 as a result of the reduced deficit, deteriorated significantly in 2014 to -2.7% of GDP, although it is expected to broadly stabilize at this level. However, despite substantial progress, the quality of the fiscal correction raises concerns, with a high share of revenue side measures targeted most notably towards a few selected sectors. Moreover, growth potential is threatened by high financing costs, contributing to general vulnerability of the economy.

Hungary's competitive industrial sector has formed the backbone of a weak economic recovery since the financial crisis.



Benefitting from its integration into European supply chains as a consequence of sizeable pre-crisis relocations of production, particularly in the car industry, the sector's output moved in close tandem with the recovery in central European industrial production in recent years. Industrial production, fell by 17.3% in 2009 and rose by 10.3% in 2010 (Figure 4.11) due to an increase in funding of foreign firms. Discounting 2010, labor productivity, industrial production, and business confidence were lower in Hungary than in the Czech Republic and Slovakia between 2008 and 2010, reversing earlier trends. Divergence has been growing since the crisis. Output loss in Hungary since 2008 is among the harshest in the region, while employment levels have generally been steady.

4.14 Hungary Business Indicators	1993-1999	2000-2004	2005-2007	2008-2012	2015
Labor Productivity, change	1.9	4.87	2.93	2.66	0.6
Industrial Production	7.9	7.72	8.17	-0.68	7.4
Business Confidence	-2.63	-6.32	-8.27	-13.34	4.88

Manufacturing has thus far been shielded from Hungary's crisis taxes; on the contrary, carmakers in Hungary receive maximum subsidies permitted under EU rules. Nevertheless, Hungary's ongoing credit crunch and policy uncertainty due to the current government's erratic unorthodox economic policies might undermine necessary investments in the sector. Moreover, the security and stability of private enterprise in Hungary remains tenuous. Business confidence, which has been negative for the past decade, finally rose in 2014, but remains below 8%, and consumer confidence stands at negative 20%. Notably, business confidence was lower prior to the crisis, suggesting business leaders understood hidden weaknesses despite nominally positive indicators. A fall in investment, capital stock, and total factor productivity should further depress labor productivity.

In 2011, the Hungarian government established the Hungarian Trade and Investment Agency to encourage foreign companies to invest in Hungary, facilitate bilateral trade, and support the activity of Hungarian small and medium sized enterprises (SMEs). Subsequently, the government announced a plan to sign "strategic cooperation agreements" with key investors and large foreign producers, with the aim of preserving their operations in Hungary, and thereby contributing to growth and employment. Since 2010, both personal income and business tax rates have been reduced to spur and support private investment and consumption (Figure 4.12). Indeed, since 1989, Hungary had been a foremost destination for FDI in Central and Eastern Europe, due to its high quality infrastructure, labor force, and central location, with the largest capital investment targeted toward the automotive industry, software development, and life sciences. However, FDI has slowed considerably since the 2008 global crisis (Figure 4.8); Hungary's relative advantage compared to regional competitors has slipped as a result of increasing obstacles and disincentives to investment, including a complicated and unpredictable tax code marked by extremely high crisis taxes, opaqueness of business and public sector proceedings, reports of corruption, and a progressively more hostile rhetoric regarding foreign businesses and private enterprise. In December 2010, a group of European companies filed a complaint against Hungary with the European Commission, arguing that the crisis taxes undermined foreign firms in favor of domestic companies. The IMF (2010) has also criticized Hungary's the tax code, stating, "The levies are difficult to justify on economic grounds as they discriminate among sectors and send negative signals about the government's attitude towards foreign investment, which is critical for Hungary."

The 2012 consolidation effort was predominantly driven by increases in revenue, which accounted for approximately two thirds of the fiscal measures. The VAT, which had been set at 25% since 2009, was raised to 27%, the highest in Europe, with the reduced rate fixed at 18% (Figure 4.12); social contributions were increased to 47% in 2013, with the burden falling entirely on employee contributions; and employment tax credits eliminated. In contrast, the flat personal income tax rate was halved in 2011, and again in 2013. The nominal corporate tax rate was similarly lowered from 20% to 19% in 2010, and a preferential corporate tax rate of 10% was introduced for SMEs. However, a series of corporate surtaxes were concurrently introduced for a number of sectors, including energy, telecom, retail, and banks. Indeed, sectoral taxes increased from 0.5% of the GDP in 2009 to 2.5% of the GDP in 2013. The initial "crisis" taxes, introduced in 2010, were set to be phased out in 2013, but with the exception of the retail sector, were instead reinstated and in some cases expanded that same year (EU Commission, 2013). The surtax on energy profits increased from 8% to an astonishing 31%, and was broadened to encompass public utility companies, raising the actual tax rate on industry profits to over 50%.

A new duty on financial transactions of 0.7% of GDP was added to the permanent bank levy, which at 0.5% of the GDP was already the highest tax of its kind in Europe. The government justified these new actions as an endeavor to address the problem of insufficient competition due to market power of the financial sector; competitiveness problems in the retail segment permitted banks to increase their interest margin well above the change in funding costs. However, it is doubtful whether the policy steps taken so far will solve the issue of monopoly pricing, while decreasing banks' market power without restoring a normal taxation environment could endanger financial stability. The financial sector has been unprofitable for three out of the last four years. Banks have attempted to pass through the negative effects of these taxes and regulatory burdens to their customers with higher interest rates on existing loans and rising fees for financial transactions, prompting new government measures and triggering a negative feedback loop for the economy. The tax structure, burdened by no fewer than six corporate tax regimes, has grown increasingly complicated, and public administration has not been reformed (EU Commission, 2013).

Furthermore, banks have been commanded to compensate borrowers for "unfair" conditions on euro and Swiss franc loans issued in the mid-2000s, when the Hungarian forint was riding high, resulting in $3bn of bank losses by 2014, with additional damages expected as all remaining foreign currency loans are converted to forints in the coming months. This exchange was slated to take place under a more favorable 2008 exchange rate; in late 2014, however, the government announced the conversion would take place at current market values. Hungarian ownership of banks rose above 50% in 2014 with the state purchase of two major foreign-owned banks, and Prime Minister Orbán has announced a target of 60% Hungarian ownership of the sector. Such recessionary pressures, punitive measures, high credit risk, and negative internal capital generation capacity have contributed to a quick pace of banking sector deleveraging, tightening conditions on new lending, and declining investment demand, resulting in a historically low investment rate. The stock of outstanding corporate loans fell by 25% between the last quarter of 2008 and 2012, and households have been unwilling to borrow due to high repayments and general economic uncertainty. In 2014, former finance minister Lajos Bokros warned that the banking sector was being “punished,” and Gyorgy Matolcsy, the governor of the Central Bank, stated that he expects a number of foreign-owned banks to withdraw from Hungary. In an effort to regain Hungary’s investment grade, the government has pledged to lower the tax on banks’ assets by 2017, and begin to review other levies in 2015, after foreign-currency mortgages are phased out and the credit supply is expanded.

The Hungarian financial sector grew quickly in the pre-crisis years, mainly due to external funding, and the net external debt of the banking sector reached 30% of the GDP by the end of 2008. However, between 2010 and 2012, rapid deleveraging reduced the net external debt by nearly 50%. With assets totaling 183% of GDP, the relative size of Hungary’s financial sector lags well behind that of the euro area, with a weighted average of 330% GDP.

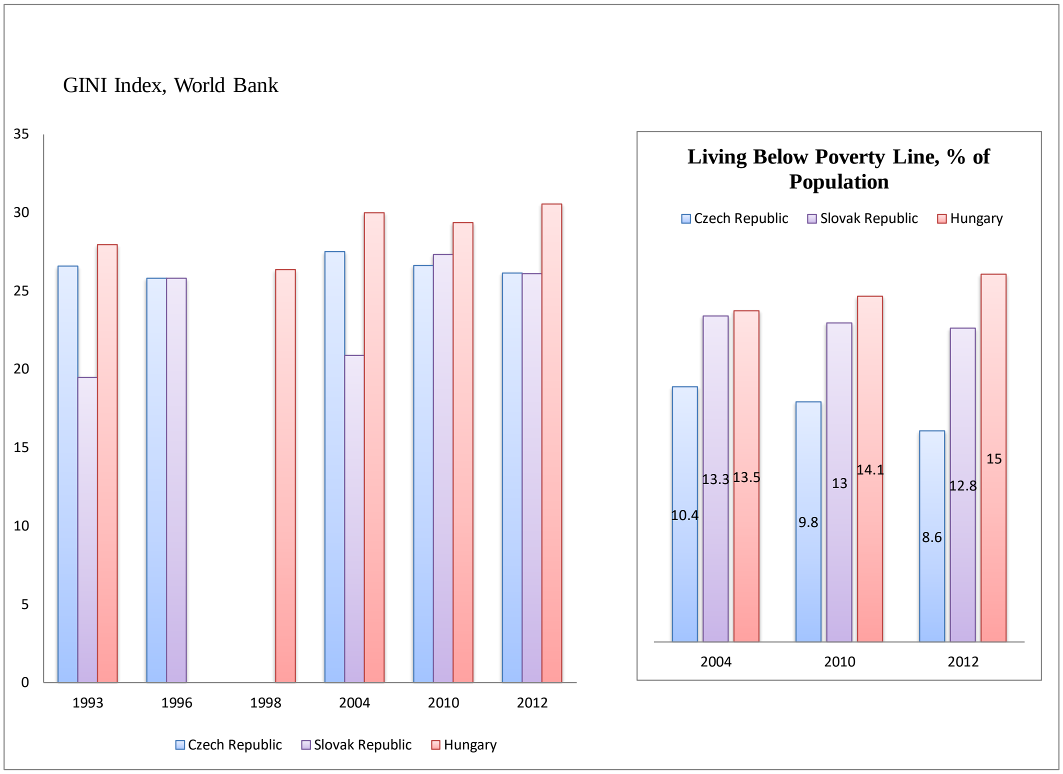
4.15 Hungary Banking Sector	1995-1999	2000-2004	2005-2007	2008-2012	2013	2015
Share Foreign Currency Denominated Loans			60	67.7	53.5	

Systemic risk due to FX loans					21.50%	
Share Non performing Loans	5.3	2.8	2.4	10.2		11.66
Capital Adequacy Ratio	15.83	12.94	11	14		
Domestic Credit from Banks, % GDP	24.05	34.4	47.67	57.8		36
Domestic credit to Private Sector as share of GDP	27.41	34.92	48.2	58.22		36.12

Still, some positive developments have recently emerged. With a capitalization rate of 15%, banks seem well poised to withstand adverse shocks. Additionally, while the combined balance sheet of the commercial banks had been reduced since 2010, the decline ended by the end of 2013 as the loan-to-deposit ratio fell to 110% from 160% in early 2009, and deleveraging decelerated (EU Commission, 2013). Foreign banks have slowed their withdrawal of external funding from Hungary. Nonetheless, the aggregate picture guises substantial variances between banks. Although foreign-owned big banks still maintain a dominant market share of 62% in private sector lending, their profitability has been relatively lower and their retain the highest loan-to-deposit ratios at 140%, suggesting that strong deleveraging and a fall in total lending volumes will persist. Moreover, the banks are deeply encumbered with poor portfolios in both the corporate and household sector. In 2014, 18.5% of corporate loans were classified as delinquent, and more than a third of household credit was either delinquent or non-performing. The Central Bank has announced it will commence a program to purchase bad commercial real estate loans below market values in 2015. Yet any major improvement in terms of portfolio quality is obstructed by generous provisioning rules for restructured loans, inefficiencies in resolution procedures, policy uncertainty, and a weak operating environment.

Social Expenditure and Human Capital

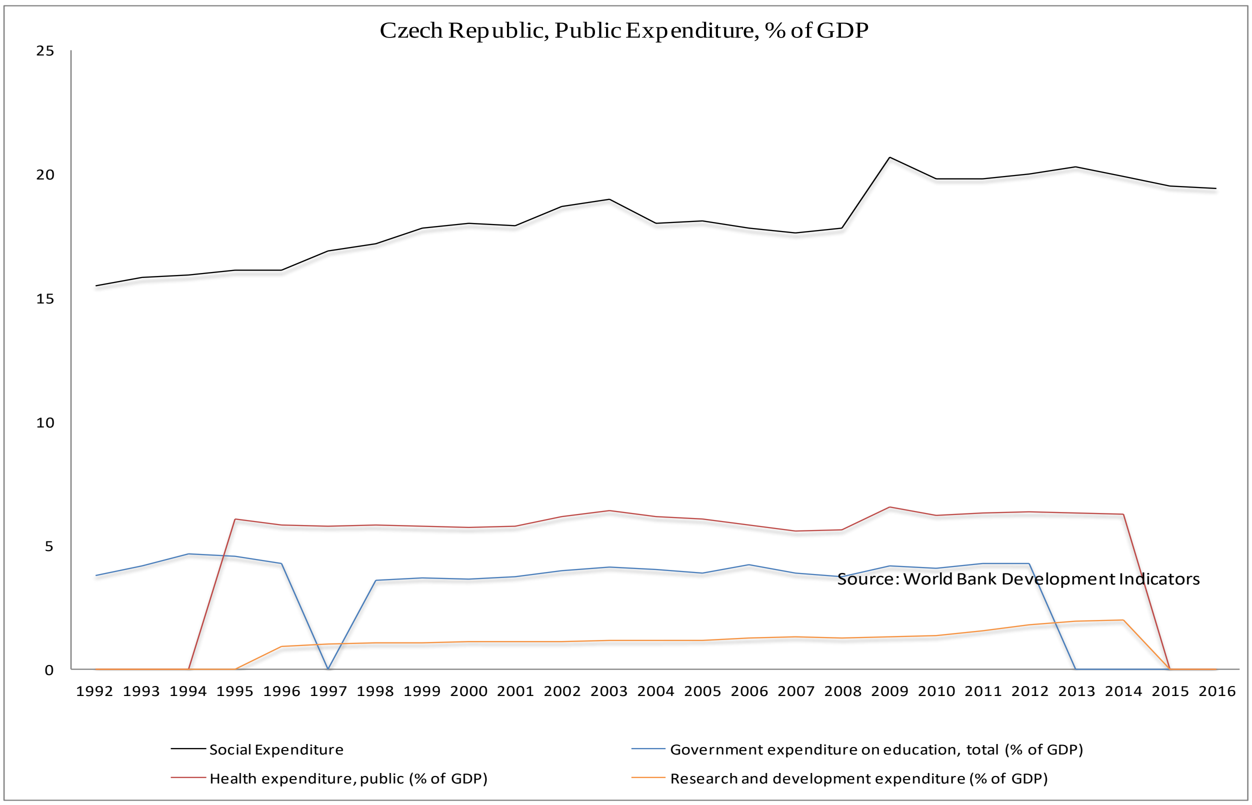
Social expenditures in Central Europe remain relatively high. Certainly, such investments have contributed to an able and educated labor force, which has been critical to driving production and productivity rates. However, in many cases, the economies are burdened by government spending on welfare and assistance programs. The Czech Republic, which eliminated the greatest number of protections following liberalization in the 1990s, appears to have the most stable public spending sector. However, Slovakia maintained and reinstated protective measures following the Velvet Divorce. Correspondingly, high unemployment and welfare spending have exerted the greatest negative pressure on the economy over the past two decades. Hungary's high levels of debt and deficit likewise display overly high levels of government expenditure. Astonishingly, despite this trend, Hungary has the highest levels of poverty in the region, which have grown since the financial crisis. Inequality and human capital indicators, too, lag behind the region, pointing to misappropriation and ineffectiveness of Hungarian assistance programs since the transition, and particularly since the 2008 crisis.



Czech Republic

The Czech Republic is characterized by high human development, the lowest poverty rate among EU member states, and low inequality when compared to other post-communist countries. Unemployment has remained remarkably low throughout the financial crisis and the subsequent recovery (Figure 4.16). Workers in the Czech Republic are perceived by employers as having an above average level of education and ability, and the Czech labor force is highly skilled even by the standards of developed market economies. The structure of Czech exports suggests that the country continues to enjoy competitive advantage in goods that embody both relatively high inputs of capital and professional, technical, and skilled labor.

However, high pension and health care costs associated with the Czech Republic's unfavorable demographic trends and ageing population pose a risk to the long-term sustainability of its public finances. According to the European Union, at current rates, the pension expenditure contribution to the long-term sustainability gap, which reflects the adjustment effort needed to ensure that the debt-to-GDP ratio does not increase, is projected to amount to 2.2% of GDP over 2016-2060, some 1.4% higher than the EU average. The increase in the ratio of pension expenditure to GDP in 2010-2060 is projected to be 2.7%, 1.1% higher than the EU average. Lower pension indexation was introduced in 2013 and is scheduled to last through 2015; actual increases in pension expenditure should therefore be higher than in aforementioned figures.

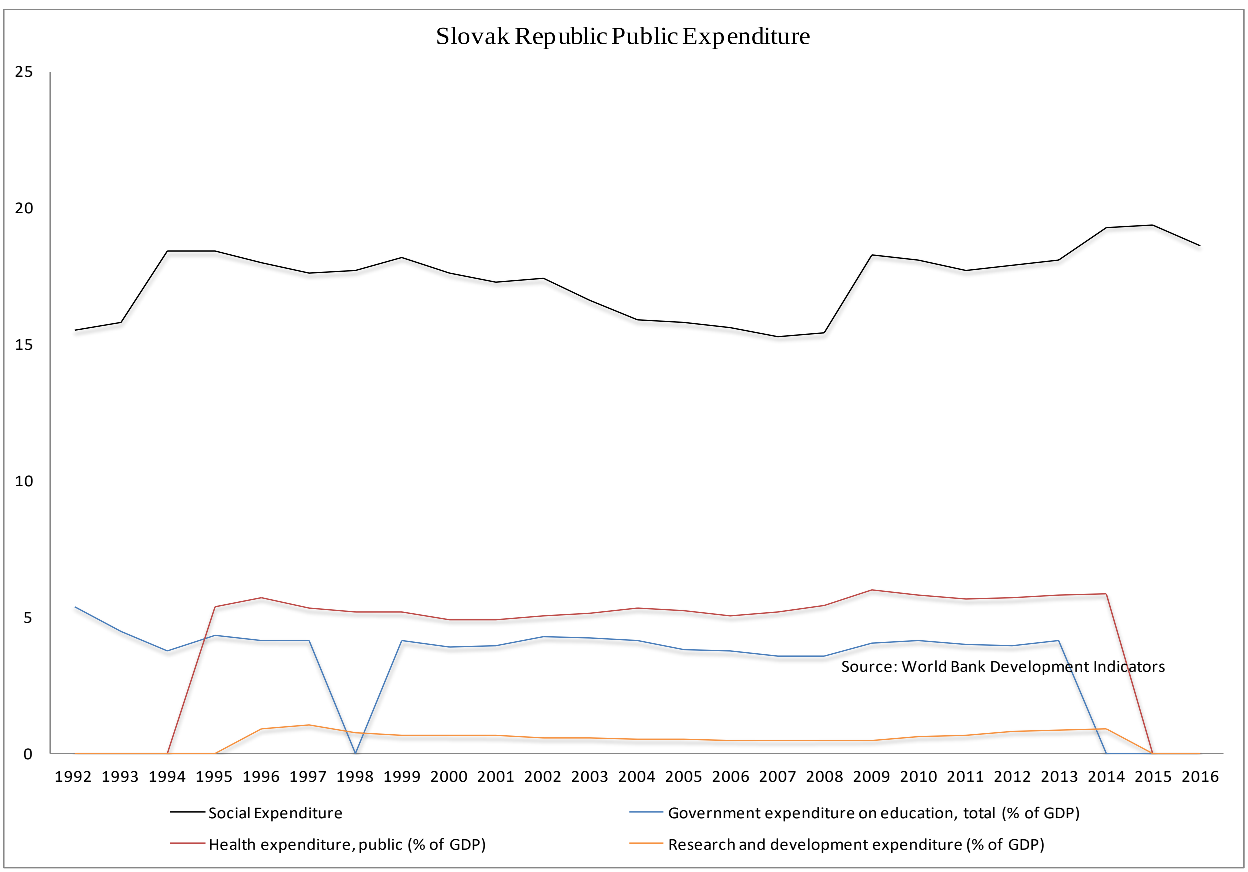


In 2011, the Czech government begun pension reform that entered into force in 2013 (with an override of an attempted Presidential veto), and divided the Czech pension system into two autonomous pension pillars: an existing pay-as-you-go scheme; and a new second pillar funded through capital contribution rates. Yet due to low public participation in the new system, and the new Czech government has already announced plans to dismantle it. In its place, the government announced a revision mechanism that will align the retirement age to changes in life expectancy in order to prevent further deterioration of the sustainability gap (EU Commission, 2012). Retirement age is highest in the region, yet with high life expectancy, the gap also tops CEE counterparts (Figure 4.16) Additionally, the state is promoting measures to increase the employment rate of individuals over 55 by stimulating labor demand, public information campaigns and learning centers for seniors, and introducing a form of a social insurance and income tax allowance for people above 50 and working pensioners, respectively.

Slovakia

Undoubtedly, a major obstacle to further advancement of the Slovak economy and business sector is the persistently structurally weak labor market that has been marked by high unemployment rates since the country's independence. Linked to increased economic activity, the labor market registered a turnaround in the past year, and unemployment shrunk from 14.4% in 2010 to below 13% in the second quarter of 2014 (Figure 4.15). The European Commission estimates that unemployment rates will fall to 12.1% in 2016. Unfortunately, unemployment rates still stand at the 5th highest level in the OECD. The rates of youth unemployment, spurred by weak school-to-job transition, long term unemployment, and unemployment of low-skilled labor remain among the highest in the European Union. In 2013, the government amended the Labor Code to increase social security taxes on temporary employment, introduce guarantees for overtime and severance pay, and raise the corporate tax rate from 19% to 23%. The new law was designed to strengthen the position of both employees and the labor unions. However, critics have argued that it will make the labor market more rigid, and certain recent surveys have suggest that some businesses consider the measure to be a barrier to job creation, as two-thirds of payroll levies are paid by employers. Therefore, even a robust return to economic growth in the near term is unlikely to alleviate problematic labor market conditions.

Despite comparatively low spending on unemployment and welfare assistance, the standing array of social policies suffers is unduly complex and riddled with deep disincentives (EU Commission, 2013). Unemployment benefits only last for six months; individuals henceforth may request welfare assistance. By contrast, the tax and benefits system continues to provide insufficient incentives for the longer-term unemployed to seek out and accept low-wage jobs, as social benefits are withdrawn rather quickly, and existing activation measures for long-term unemployed are not appropriately effective.



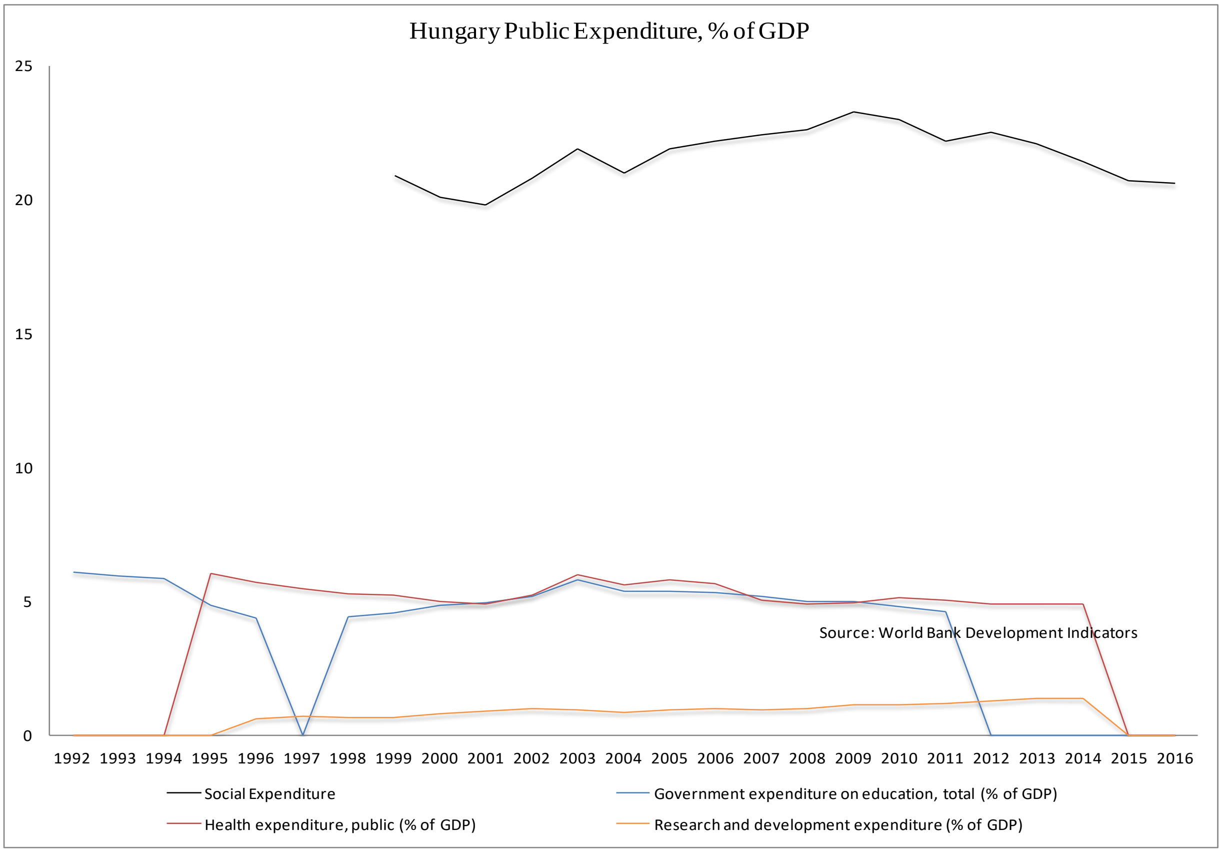
Relatively low public expenditure on education, and an absence of competitive vocational and professional training, has contributed to rising rates of youth unemployment. In 2013, the Slovak government set the objective of progressively raising public expenditure on education to 6 % of GDP by 2020 while increasing efficiency by bringing the number of schools and teachers in line with demographic developments. It has further announced it would pursue improved training of teachers, and continuous oversight of the career system for teachers that examines the quality of the education profession. However, much of the planned increase in education is likely to be outside the current government's mandate. A comprehensive new law on higher education institutions is under consideration, as is a revised funding mechanism that would link the financing of education more closely to its overall quality. A revised law on vocational education and training (VET) was adopted in 2012. It creates better connections between VET institutions and the labor market, and encourages company projects to generate new internships and apprenticeships (EU Commission, 2013).

In 2012, major changes to the pension system were adopted in order to reduce rising pension costs. The retirement age was raised while early retirement criteria were strengthened, the statutory retirement age was linked to life expectancy starting in 2017, and inflation-based indexation was set to take hold in 2018. A significant portion of contributions was reallocated to the first (pay-as-you-go) system from the second (mandatory funded) private system pillar. In the short run, this will have a positive effect on government finances through increased revenues. This trend will be reversed in the long-term, as the aging of the population will lead to greater pension liabilities. Finally, generous pension regimes for special categories such as the armed forces and police were curbed, although not as much as initially proposed. According to the

European Commission, the ratified policies should halve the projected increase in pension expenditures between 2010 and 2060, to 2.6% of GDP, shoring up the feasibility of the public pension pillar (EU Commission, 2013). Yet, due to increasing demographic shifts, the public pension pillar will remain in deficit (Figure 4.16). The current long-term sustainability gap of 4.9% of GDP remains well above the EU average of 3%, in large part due to the projected long-term cost of ageing, with pension expenditure contributing 1.5%, and health care spending adding 2% to the gap. As in the Czech Republic, the distance between retirement and life expectancy stands at approximately 15 years.

Hungary

Hungary's unemployment rates have been steadily declining in recent years, from approximately 11. 3% in 2010 to 6.3% in 2016 (Figure 4.15), and are projected to fall further; indeed, the state may well face labor shortages in key sectors in the coming years. Public expenditures have risen sharply in the last half decade, with much of the funds going to support for government operations and financing of the public debt – over 20% of the population remains employed in the government. Expenditures on social programs have conversely fallen in the last six years. Hungary devotes a relatively low percentage of its budget to human capital development, and such expenditures do not place a harsh burden on the state budget. Public spending on education and health, which amounts to approximately 4.5% of the GDP in 2011, and 5% of the GDP in 2012, respectively, well below the OECD average.

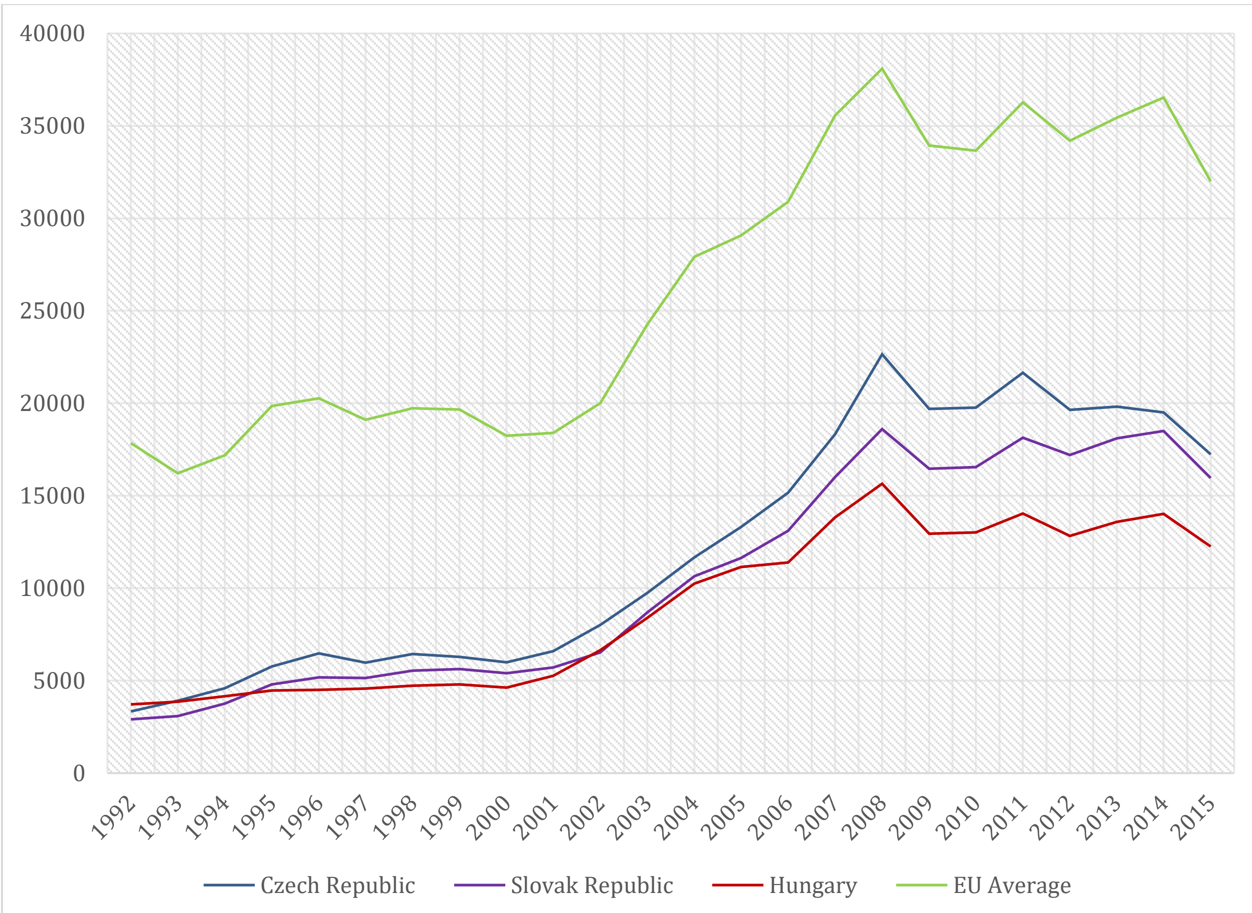


However, Hungary hence suffers from poor outcomes on human development indicators: longevity and mortality indicators are below OECD and peers averages – life expectancy increased by only 5.5 years in the past forty years, while its OECD counterparts achieved an average increase of 10 – while infant mortality rates remain well above. The underperformance of the education sector hampers further growth, particularly in high-income sectors. While enrollment rates are near-universal, and secondary school graduation rates surpass the OECD average, tertiary completion rates are among the lowest in the OECD, at 53% in 2013. Moreover, student performance across all skills has deteriorated relative to European standards.

In 1998, Hungary introduced a pension reform that combined a pay-as-you-go state pension fund with a mandatory, funded, privately managed pillar, though questions lingered about the necessary contribution rate. By 2010, roughly 70% of the labor force was under the second pillar, which offered risk diversification and a higher return on contributions. Furthermore, the government took steps to phase out early retirement schemes and tighten access to disability pensions will help boost Hungary's historically low effective age of retirement, which was the fourth lowest in the OECD in 2012. However, in 2010, the Orbán government enacted a measure to close its second-pillar pension system and transfer assets to the national treasury, effectively nationalizing pension savings. All payments to the scheme were suspended, although savers could remain in the private funds, and all contributions were redirected to the public pension fund. In late 2014, the remaining funds were closed, and the assets absorbed into the state system. In an effort to bolster sustainability of the pension system, retirement ages have been raised, and the gap between retirement and life expectancy is lowest in the region, though this is due to lower life expectancy rates (Figure 4.16)

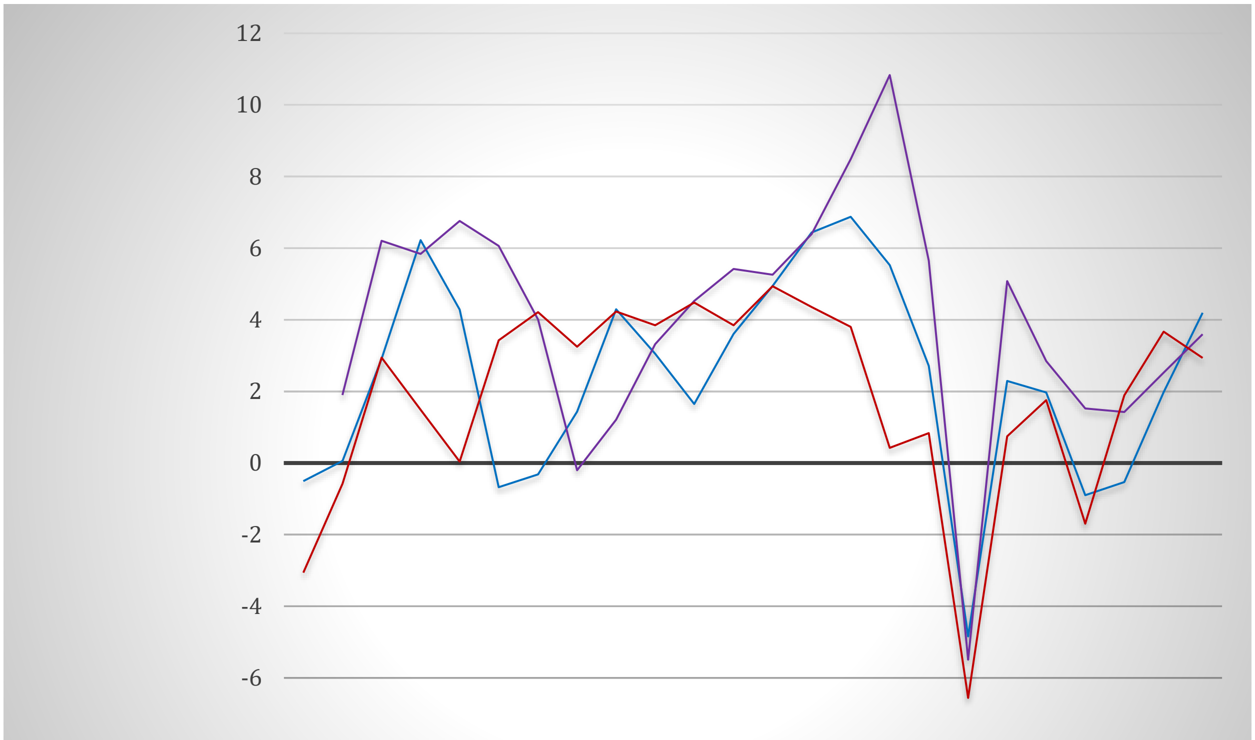
Figure 4.1: GDP Per Capita

Current US $



Source: World Bank Development Indicators

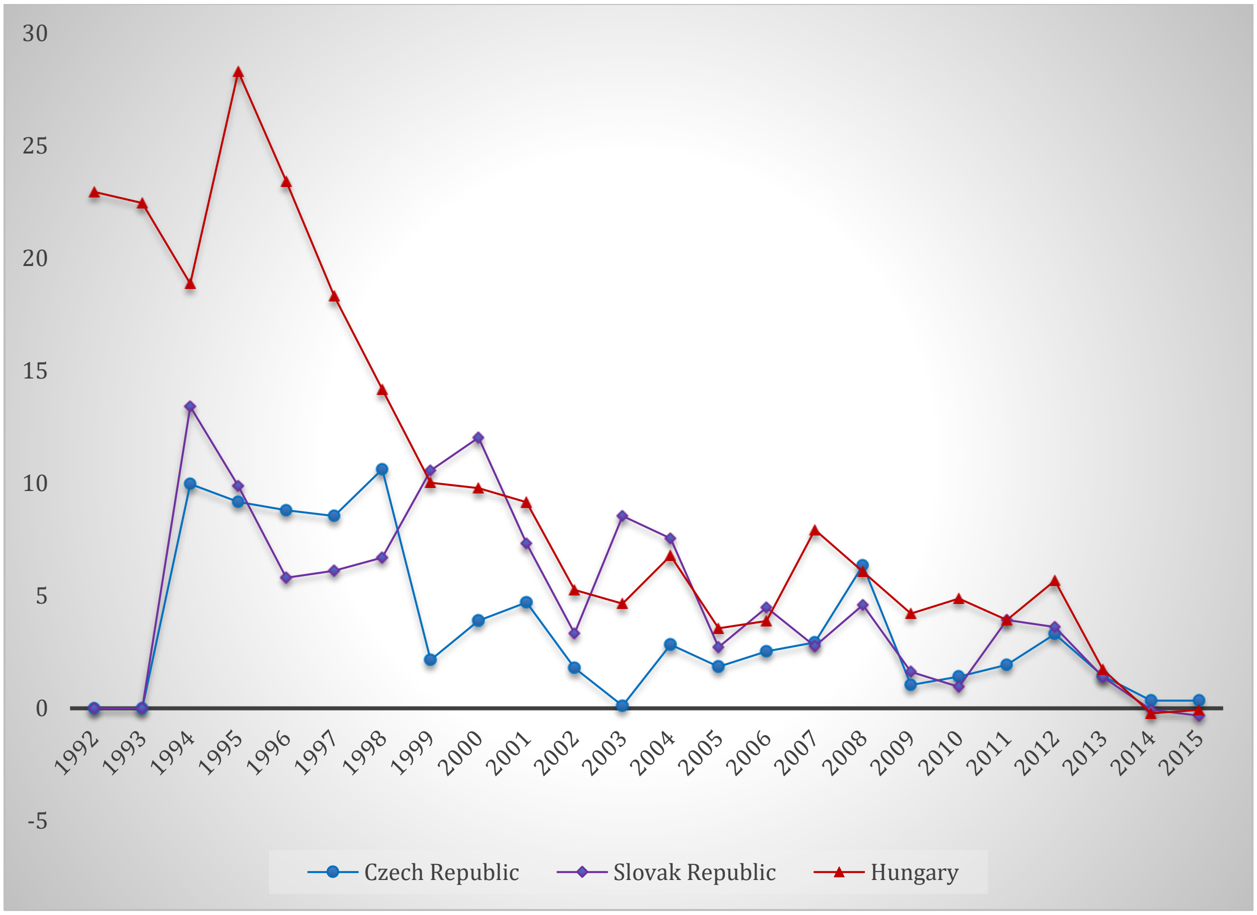
Figure 4.2: GDP Annual Growth



	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15
Czech Republic	-1	0.1	2.9	6.2	4.3	-1	-0	1.4	4.3	3.1	1.6	3.6	4.9	6.4	6.9	5.5	2.7	-5	2.3	2	-1	-1	2	4.2
Slovak Republic		1.9	6.2	5.8	6.8	6.1	4	-0	1.2	3.3	4.5	5.4	5.3	6.4	8.5	11	5.7	-5	5.1	2.8	1.5	1.4	2.5	3.6
Hungary	-3	-1	2.9	1.5	0	3.4	4.2	3.2	4.2	3.8	4.5	3.8	4.9	4.4	3.8	0.4	0.8	-7	0.7	1.8	-2	1.9	3.7	2.9

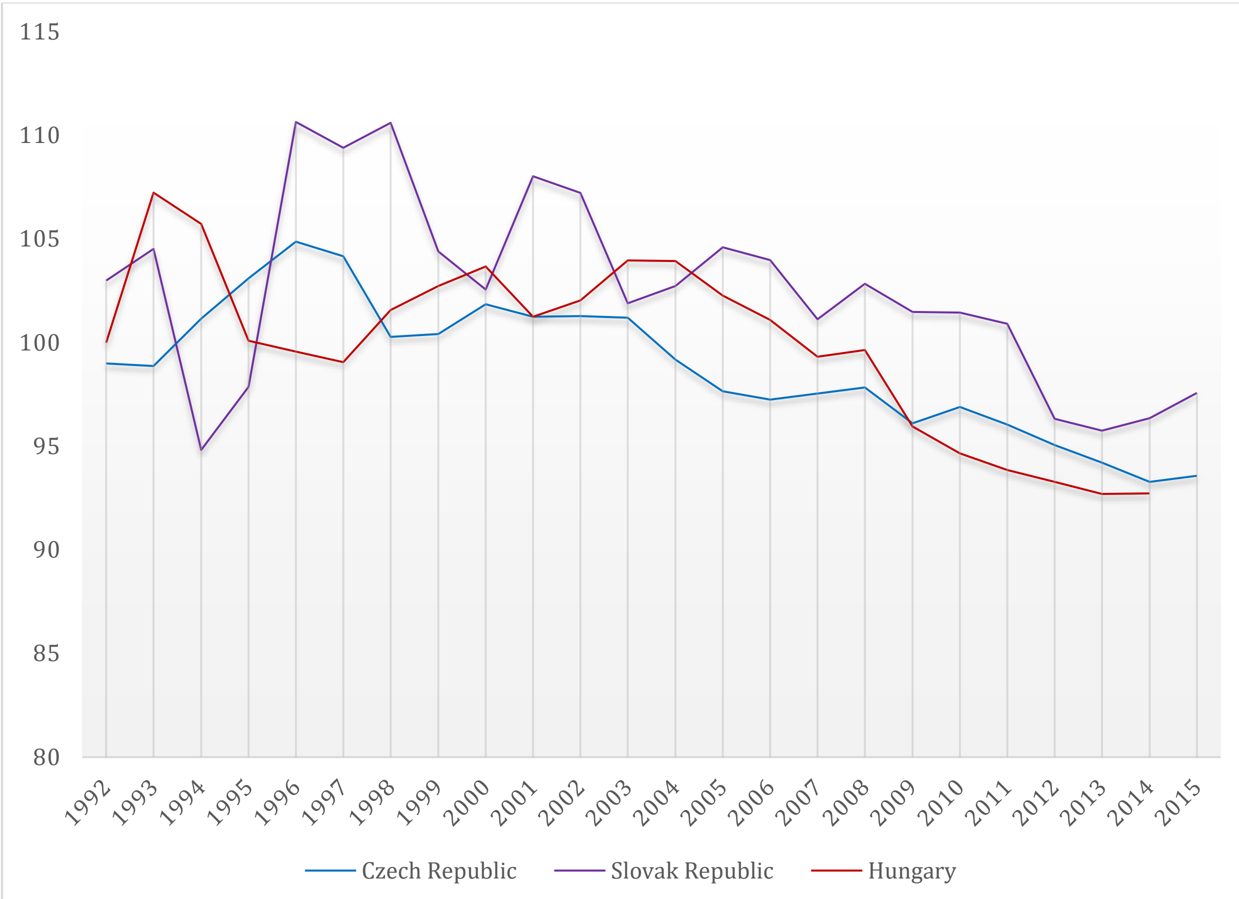
Source: World Bank Development Indicators

Figure 4.3: Inflation, Consumer Prices, % of GDP



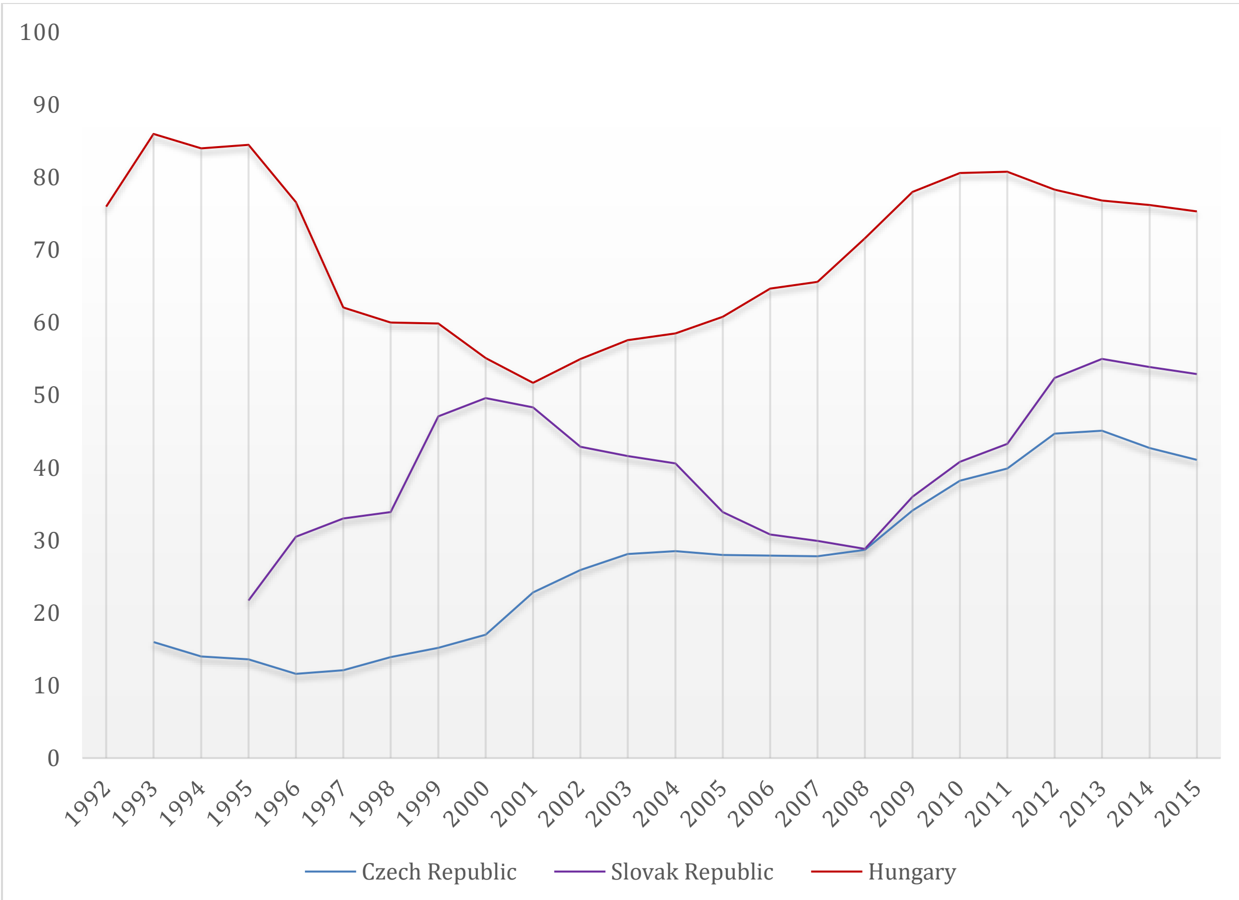
Source: World Bank Development Indicators

Figure 4.4: Gross National Expenditure % of GDP



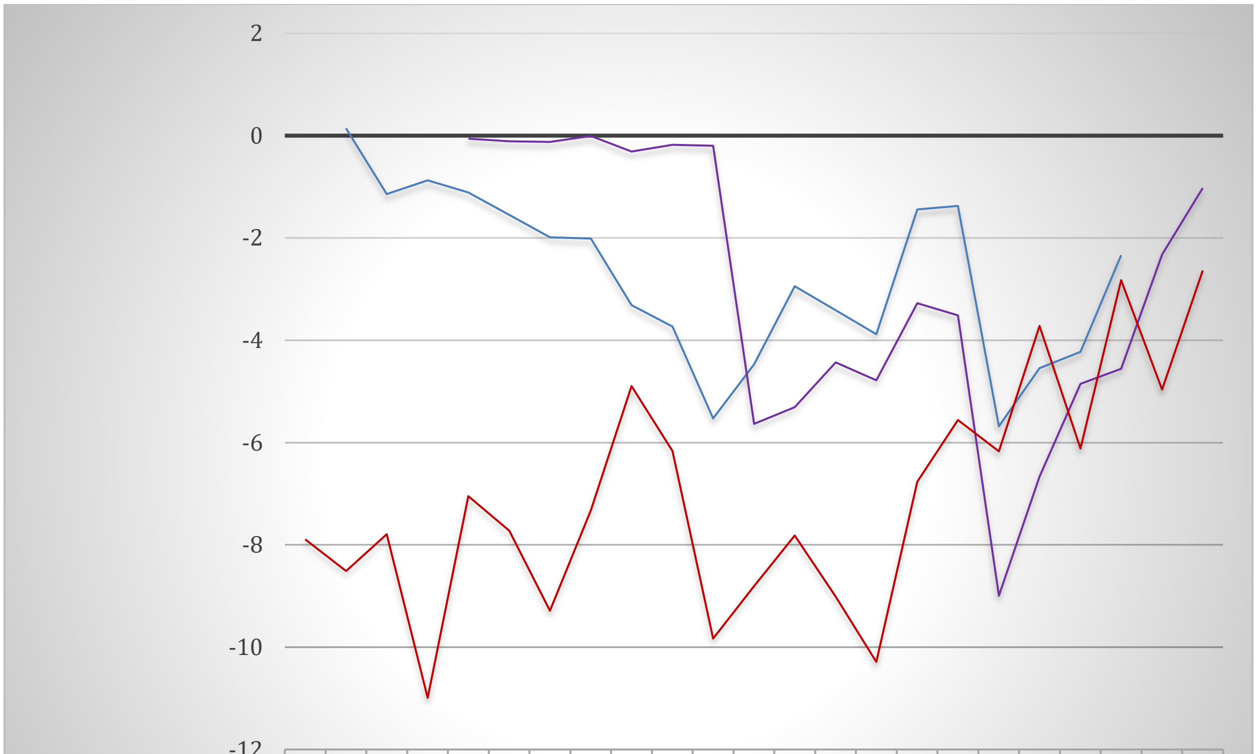
Source: World Bank Development Indicators

Figure 4.5: Government Debt to GDP Ratio



Source: Eurostat data

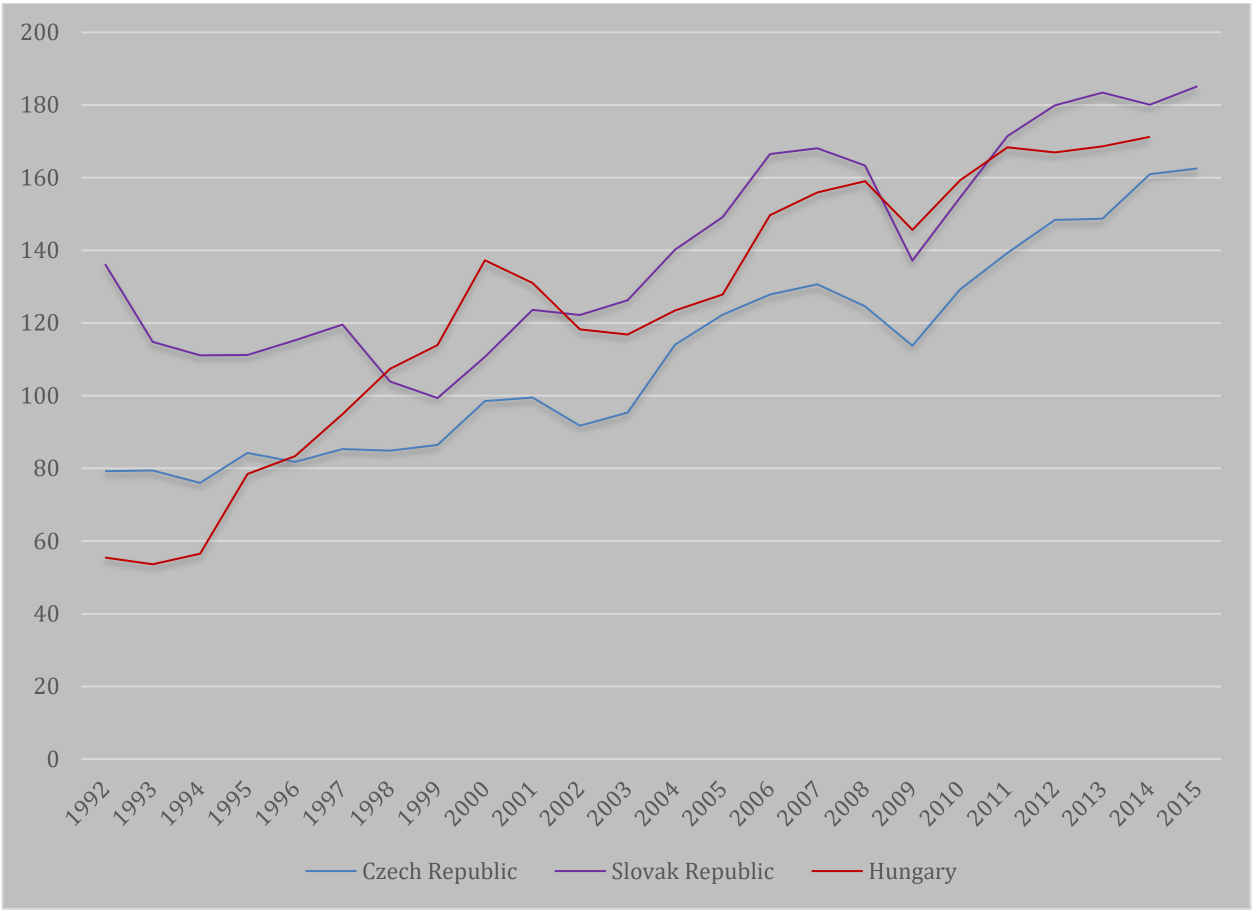
Figure 4.6: Cash Surplus / Deficit, % of GDP



	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14
Czech Republic		0.1	-1	-1	-1	-2	-2	-2	-3	-4	-6	-4	-3	-3	-4	-1	-1	-6	-5	-4	-2		
Slovak Republic					-0	-0	-0	-0	-0	-0	-0	-6	-5	-4	-5	-3	-4	-9	-7	-5	-5	-2	-1
Hungary	-8	-9	-8	-11	-7	-8	-9	-7	-5	-6	-10	-9	-8	-9	-10	-7	-6	-6	-4	-6	-3	-5	-3

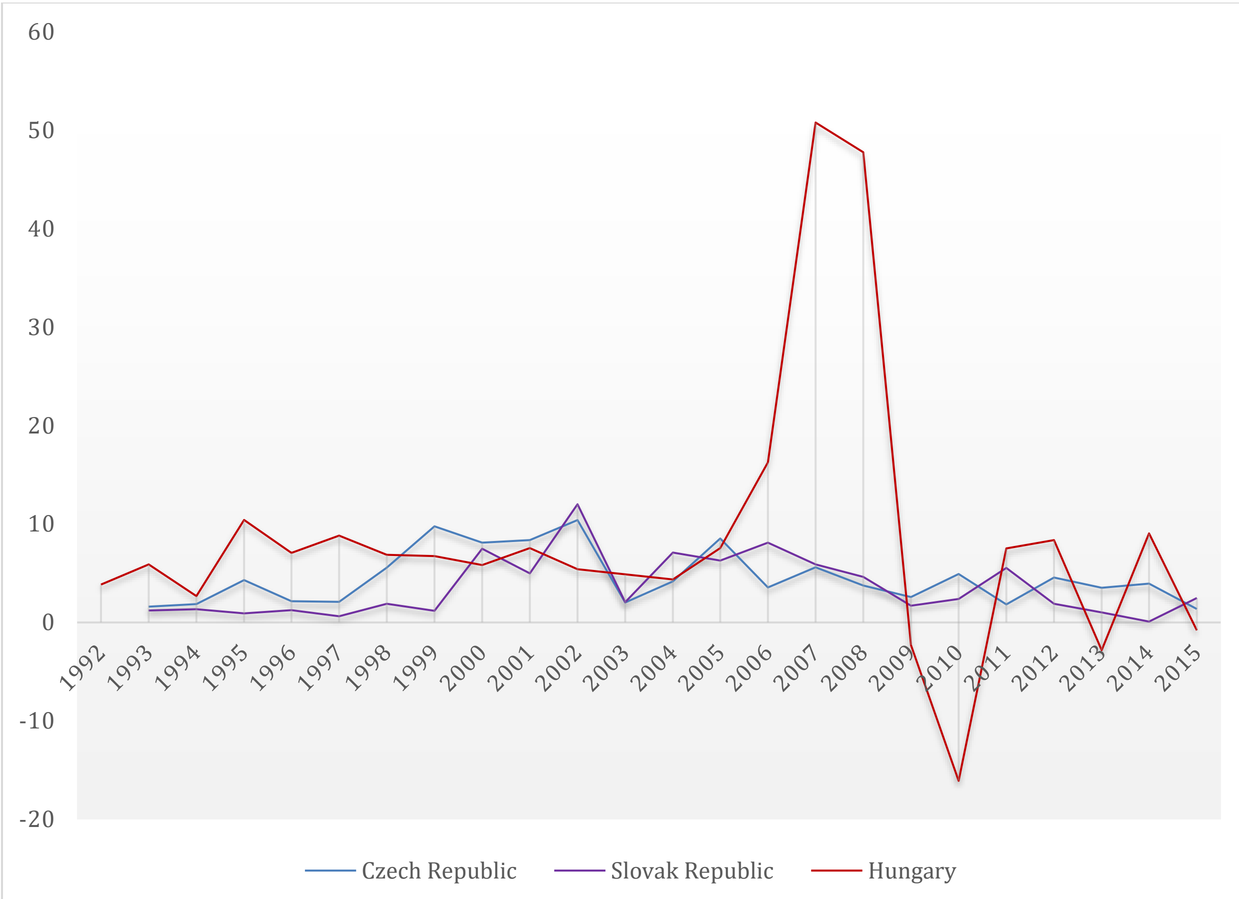
Source: World Bank Development Indicators

Figure 4.7: Exports as % of GDP



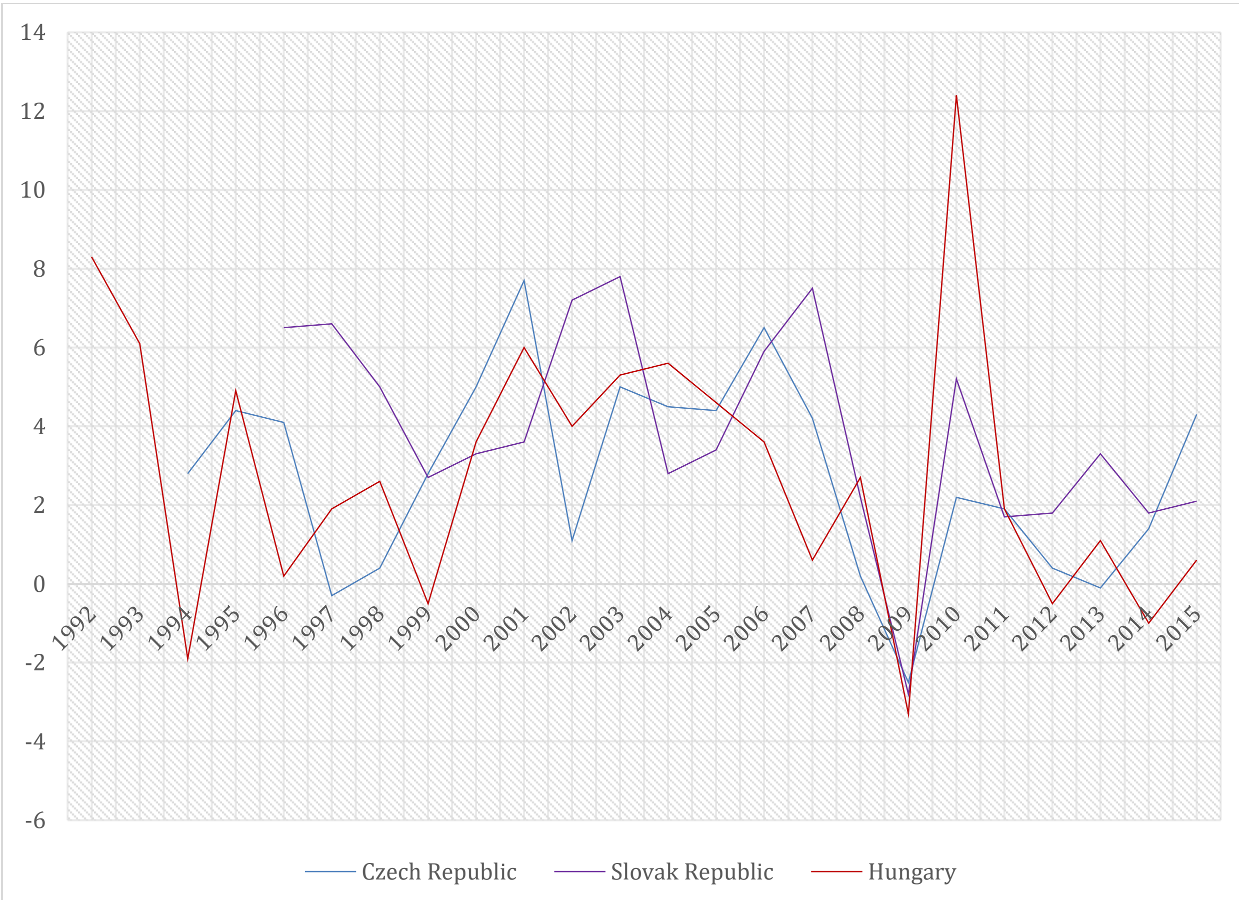
Source: World Bank Development Indicators

Figure 4.8: FDI Net Inflows, % of GDP



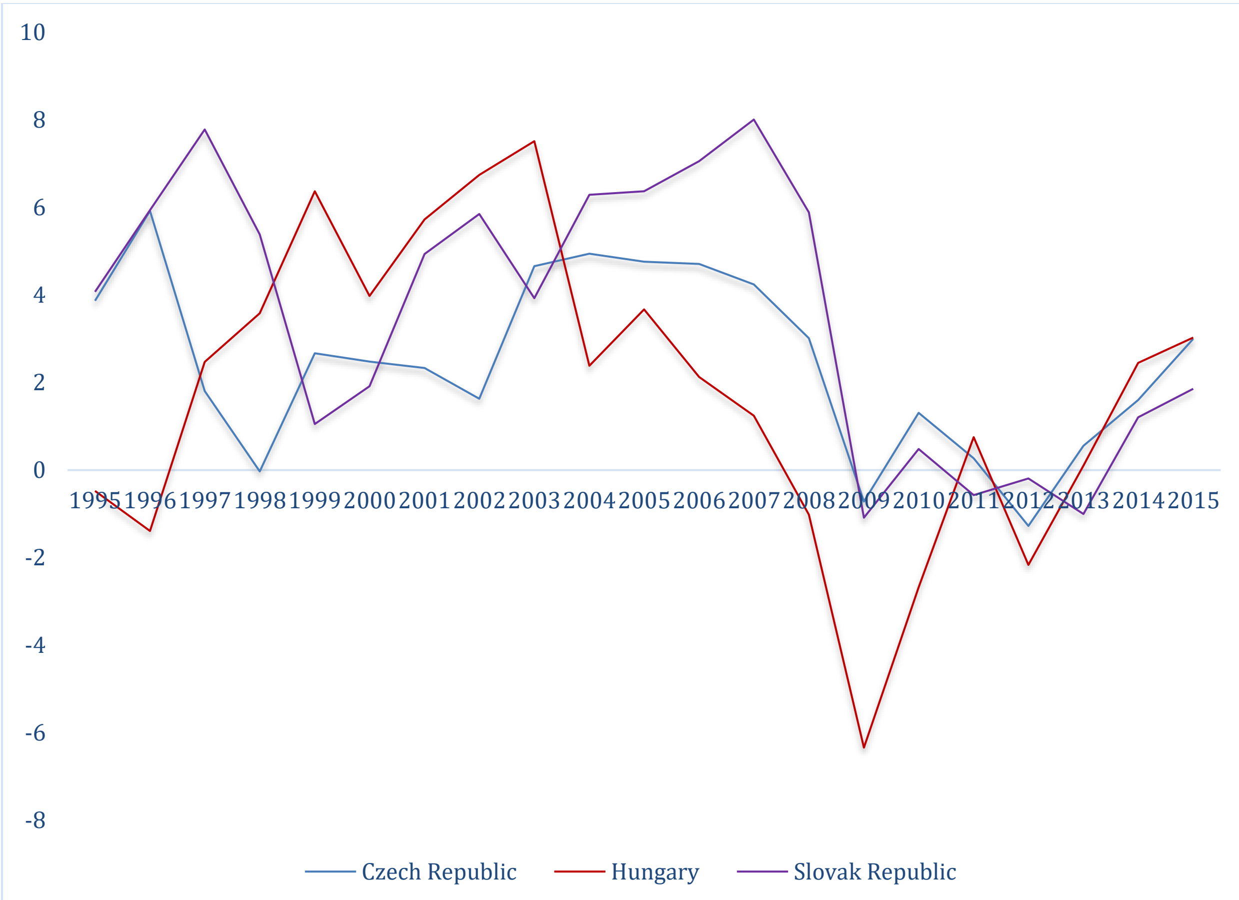
Source: World Bank Development Indicators

Figure 4.9: Productivity, GDP per Hour Worked



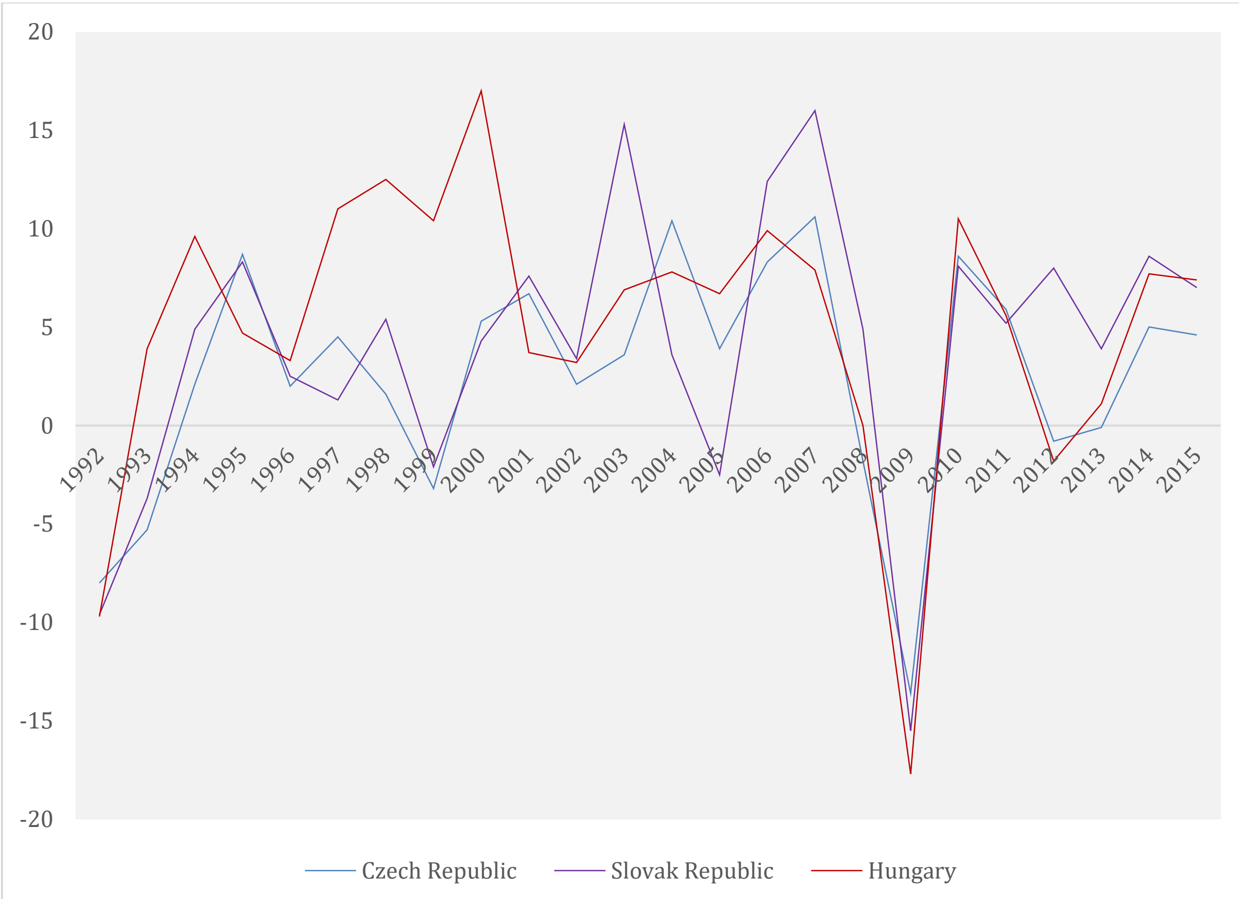
Source: OECD

Figure 4.10: Household Final Consumption Expenditure, % Annual Change



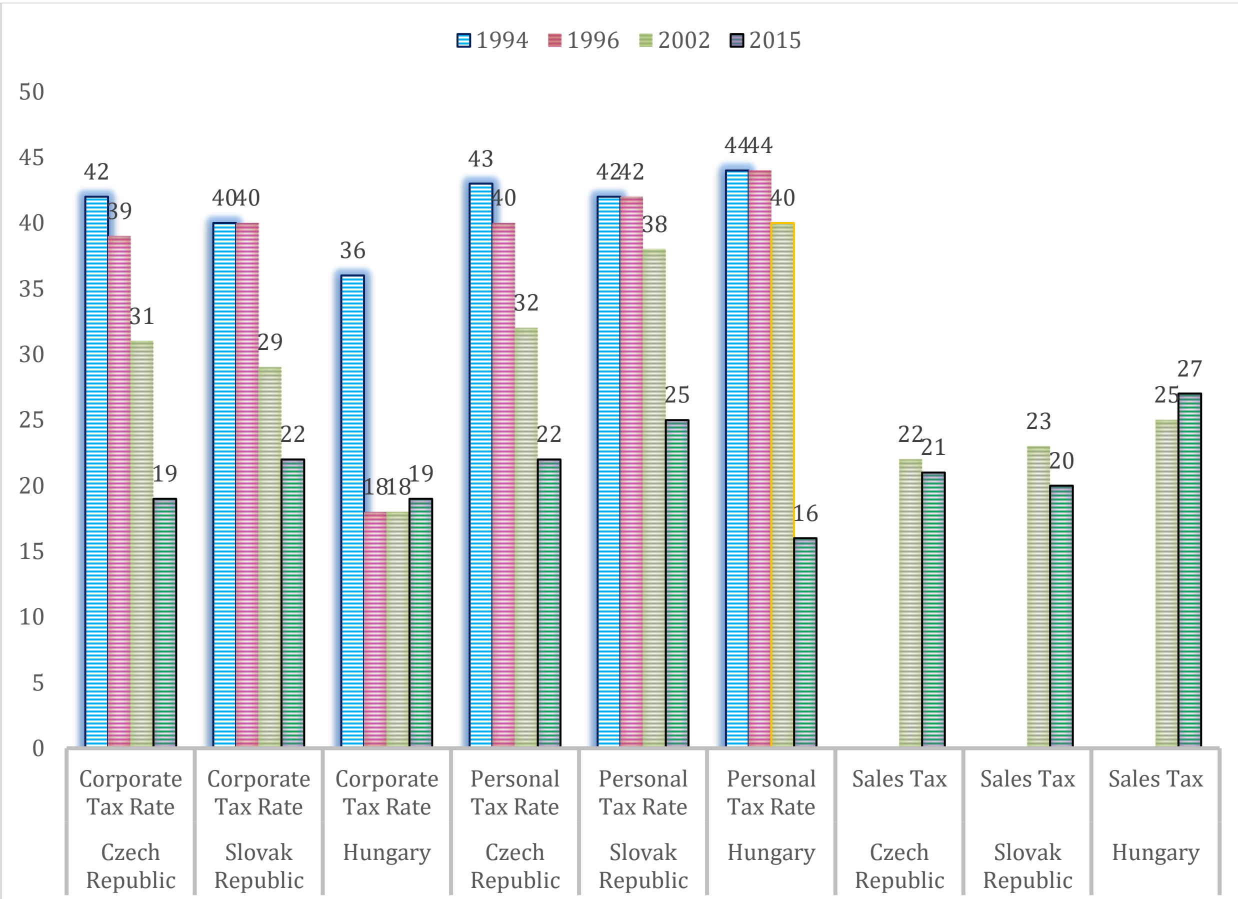
Source: World Bank Development Indicators

Figure 4.11: Industrial Production, % annual change



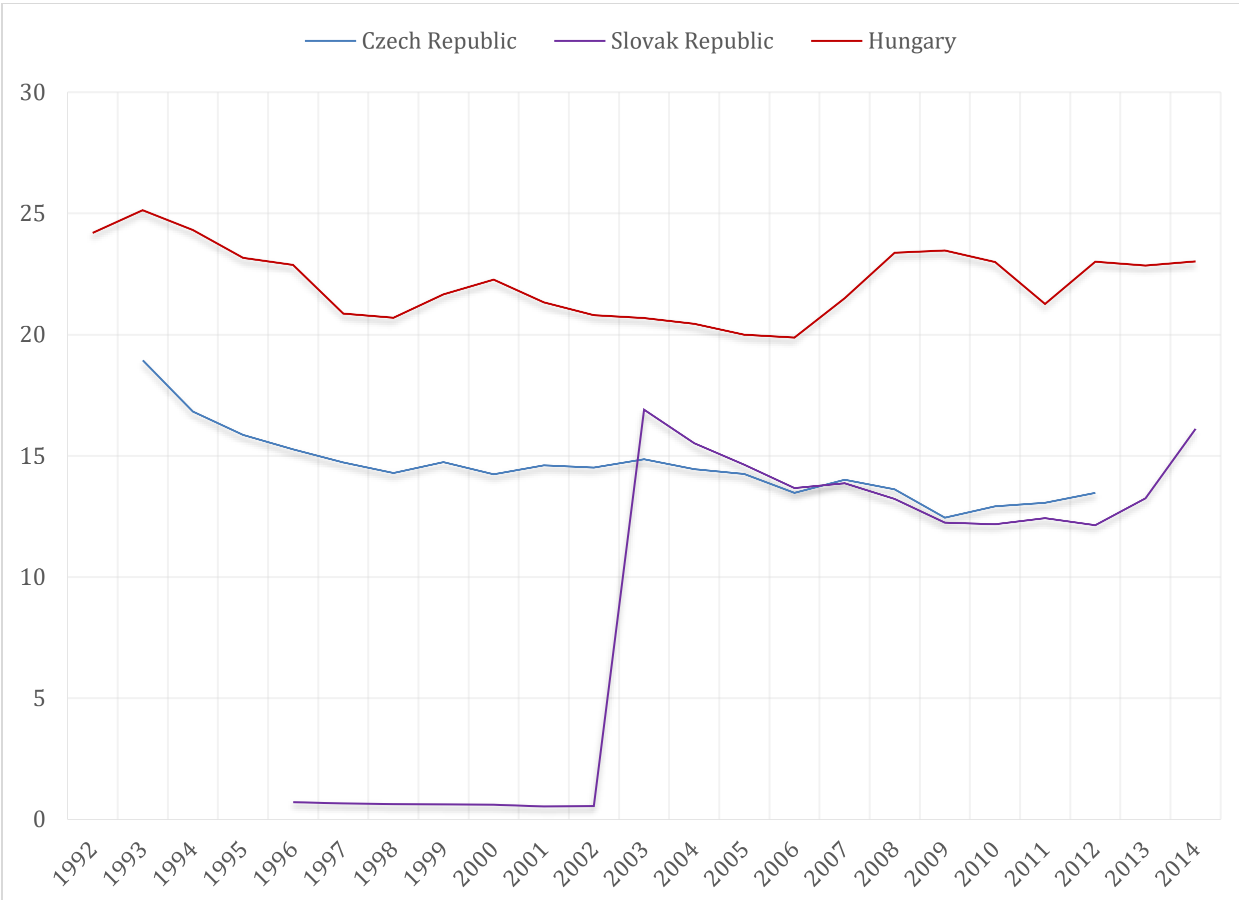
Source: OECD

Figure 4.12: Tax Rate



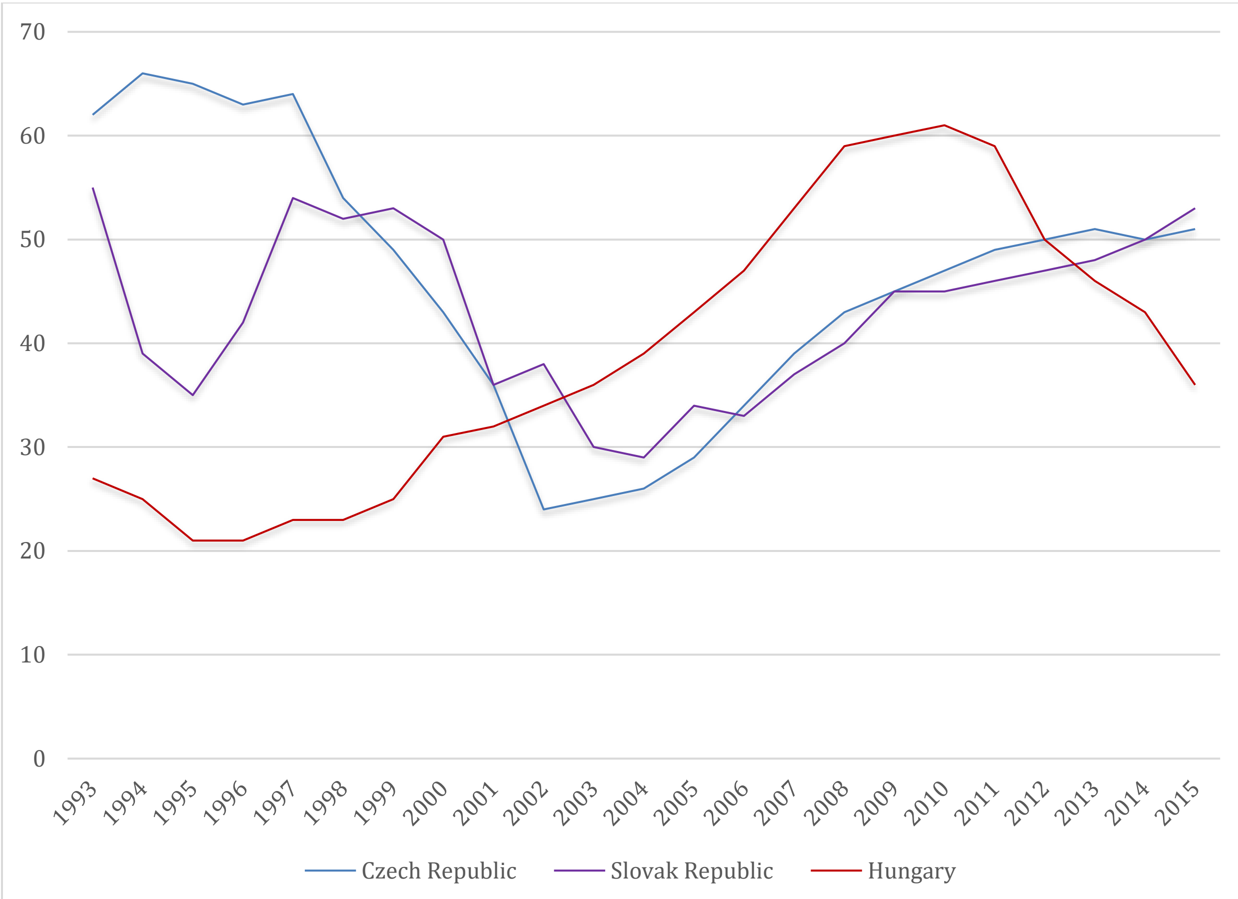
Source: Eurostat

Figure 4.13: Tax Revenue, % of GDP



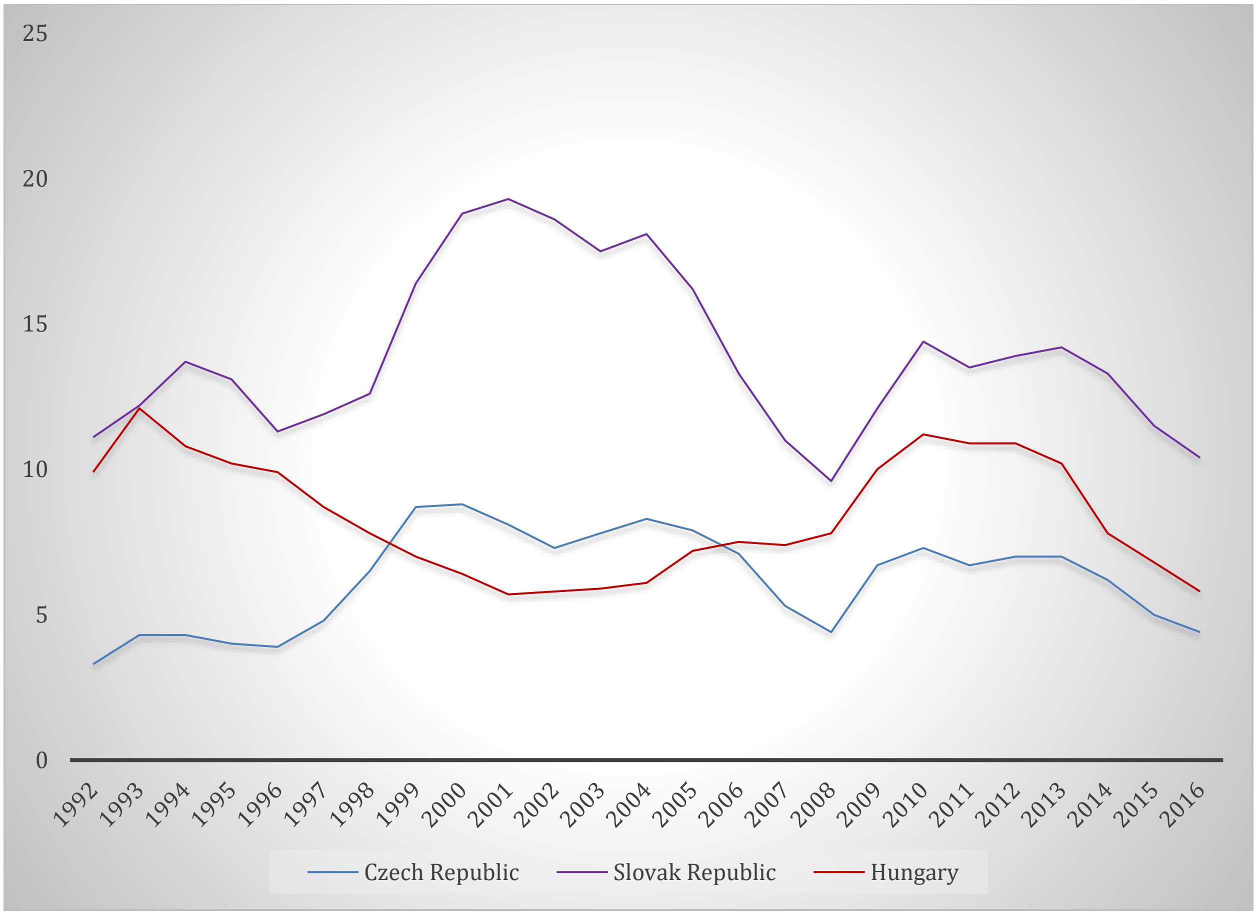
Source: World Bank Development Indicators

Figure 4.14: Domestic Credit from Banks, % of GDP



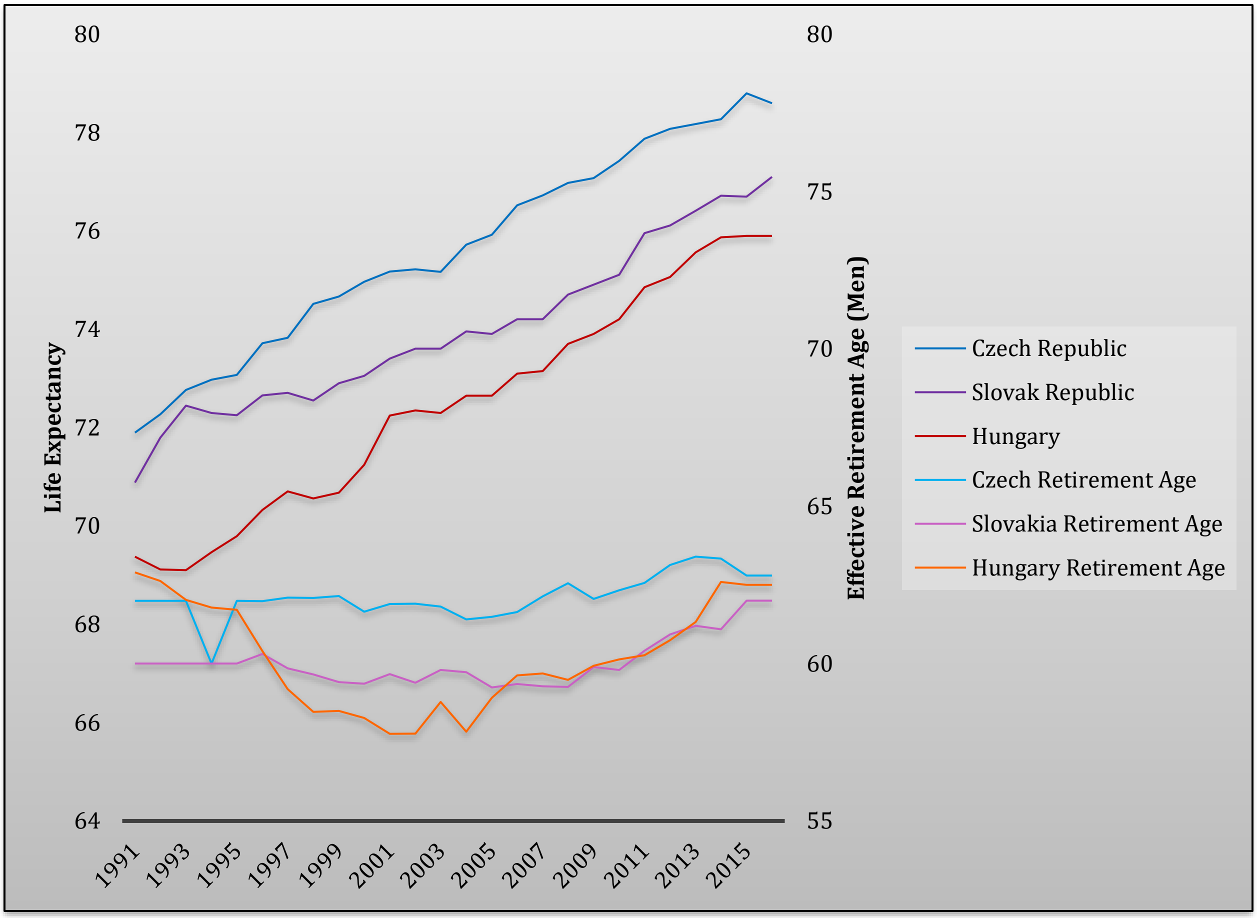
Source: World Bank Development Indicators

Figure 4.15: Unemployment, % of Workforce



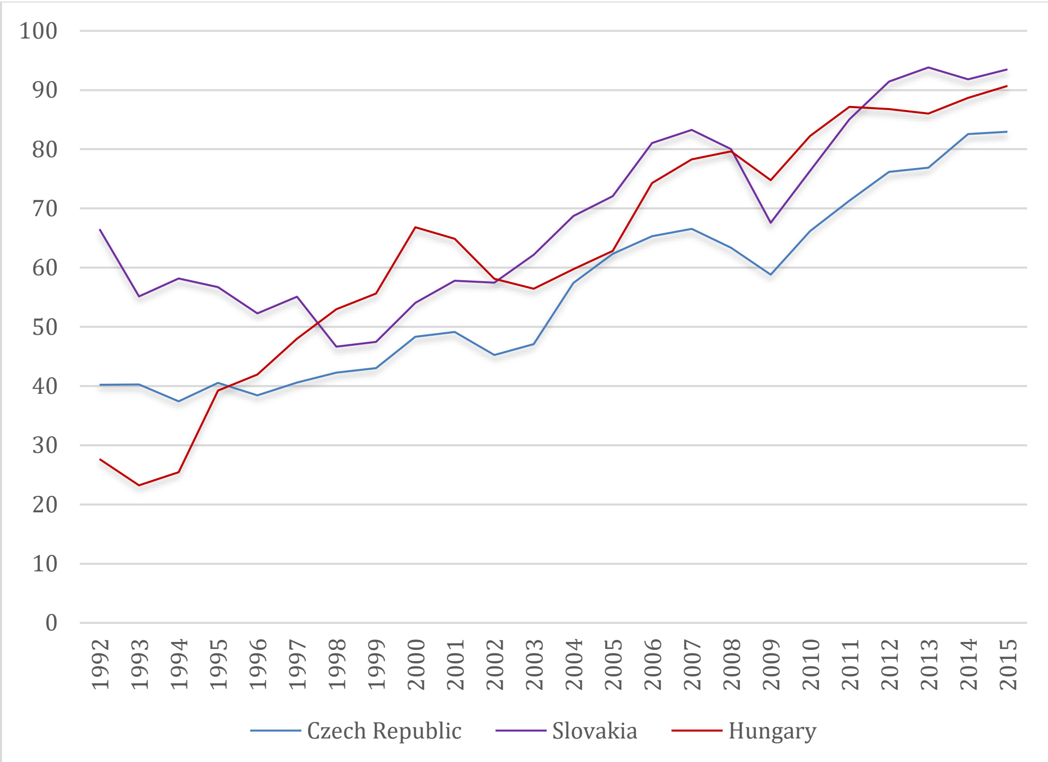
Source: OECD

Figure 4.16: Retirement Age and Life Expectancy



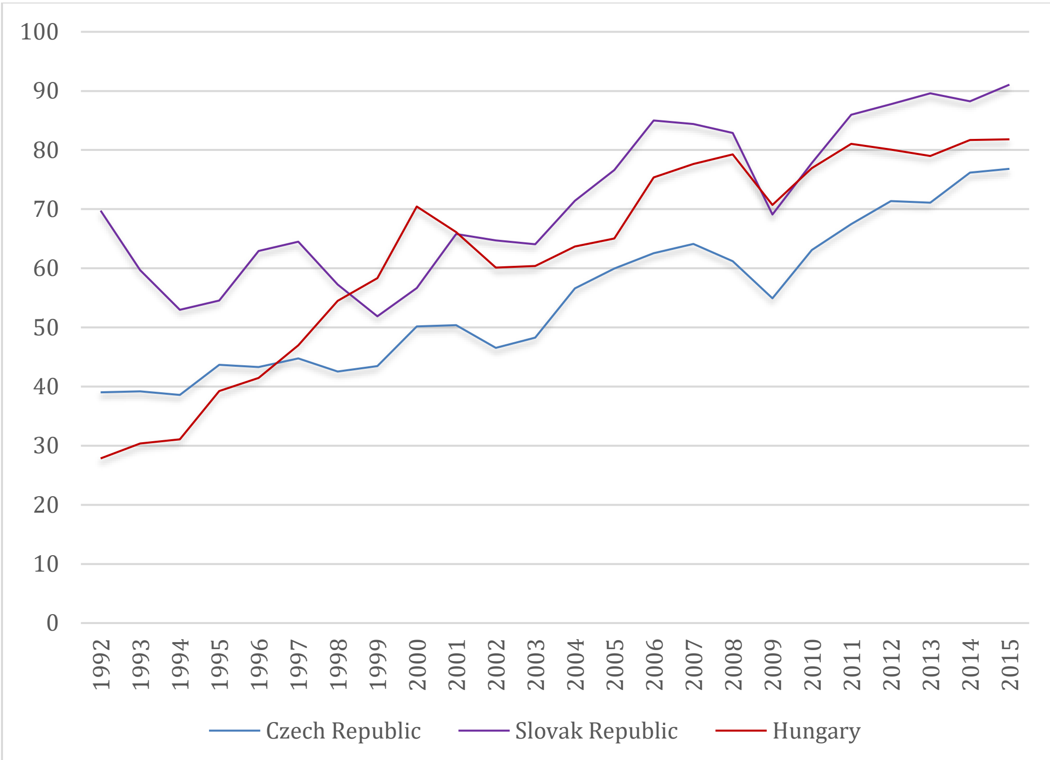
Source: World Bank Development Indicators

Figure 4.17: Exports as share % of GDP



Source: World Bank Development Indicators

Figure 4.18: Imports as share of GDP



Source: World Bank Development Indicators

CHAPTER 5: LIBERALIZATION

The role of economic liberalization – defined as the establishment of a market regime through trade, price liberalization, and competition – in driving economic growth has been a key debate in the development literature for most of the second half of the 20th century. In particular, price liberalization and competition have been theorized as central tenets of free market, capitalist systems, by scholars starting with Adam Smith. Unsurprisingly, at the dissolution of the Soviet bloc, the establishment of Western market conditions through the introduction of trade, price liberalization, and competition was the ultimate stated objective of states across Central and Eastern Europe. The role of competition in transition economies will be considered in the following chapter; this section will examine – to the extent applicable for European transition economies – the issues of liberalization.

Liberalization is extremely difficult under any conditions, and particularly after decades of protected state industries and social welfare programs. The erosion of central support for enterprises and services can be met with political resistance, particularly as market adjustments generally lead to economic losses in the immediate aftermath of liberalization. As the initial enthusiasm and support for adoption of democratic rule and free market enterprise fades, the state must maintain a commitment to private sector stewardship of the economy despite some new economic, political, and social costs. Moreover, in order to successfully move to sustainable free market systems, states must in parallel complete stabilization agendas, marked by hard budget constrains including deficit, debt and inflation control, and cutbacks in spending, in order to generate stable economic conditions. Adapting public finances to a market economy likewise requires both firms and individuals to accept the costs of economic restructuring, adverse shifts in prices, and increased competition. Yet the failure to impose such stabilization measures may lead to the emergence of shadow economies, as well as general economic weaknesses and inefficiencies.

Therefore, the states in Central Europe that were best able to complete effective liberalization programs in conjunction with ambitions stabilization plans have been best able to institute stable market systems. The Czech Republic embarked on a determined and rapid liberalization scheme coupled with strict hard budget constraints that maintained the health of the economy even in cases of external shocks or domestic challenges. Slovakia likewise followed a similar model, though at a slightly slower pace. Hungary has proved less adept at imposing hard budgets as a part of an overall liberalization program, and enacted a more gradual rate of liberalization reforms. Ultimately, the Czech model proved to be more effectual at driving economic growth. Faster liberalization designs were politically more expedient, when the Czechoslovakian transition government enjoyed broad space for implementation of new economic agendas. The continued support for this shift toward a market economy depended in large part on a stable economic environment, achieved through stabilization, and privatization programs that expanded participation in the new system, which will be discussed in the next chapter. Hungary, however, failed to achieve broad agreement on the necessary transition steps, and thus struggled to complete liberalization programs and adhere to strict hard budgets.

Review of liberalization research

While price liberalization and competition were held up as critical drivers of growth by classic authors, contemporary studies of economic liberalization have focused primarily on the impact of exports and potential gains from trade. The prevailing conclusion of these studies is that the reduction of trade barriers increases economic efficiency by allowing consumers and producers to procure items from lowest cost sources. Economists have recently sought to elucidate other possible effects of liberalization. Most significantly, studies have demonstrated that many industries have increasing returns to scale that can magnify the effects of any liberalization-induced growth; that increased trade may lead to more capital accumulation; and that expanded liberalization can increase productivity throughout affected industries. This section will provide a brief overview of major studies on different aspects of liberalization – trade, domestic, and price – before moving to specific research in transition states.

Empirical literature considers the impact of trade liberalization and openness on economic development through: increased capital accumulation, knowledge spillovers; factor price equalization; and technology transfers. These studies suggest that trade engenders openness that drives technological change, leading to growth. For instance, considering the impact of liberalization on internal economic development within a state, Romer (1990) argues that intensifying the transfer of knowledge or technological capacity through trade should propel growth. Rivera-Batiz (1996) summaries several crucial connections between trade and innovation that serves to increase growth. International trade reallocating resources towards competitive and innovative sectors and industries. Trade moreover spurs the communication of knowledge and ideas across countries with positive effects on long-run growth; promoting economic openness leads to an exchange of information and expertise. Third, external liberalization drives competition among domestic enterprises, prompting a rise in innovation stimulated growth.

There has been no shortage of studies that demonstrate a strong correlation between economic openness and growth. Yet Rodriguez and Rodik (2001) review more than a decade of empirical work to conclude the relationship between growth and trade has not been settled. Conversely, Esterly and Levine (2001) perform a similar analysis to find that national policies such as the trade regimes do affect growth, although they argue that due to the complexity and intercausal nature of the relevant factors, the extent of the impact cannot be precisely determined.

Table 5.1: Impact of Trade on Economic Growth

Author	**Year**	**Effect of trade on growth**	**Key Findings**
Romer	1990	Positive	Trade drives growth through transfers of knowledge and technology.
Rivera-Batiz	1996	Positive	Trade moves resources to competitive sectors, diffuses ideas across borders, and increases competition among domestic firms.
Frankel and Romer	1999	Positive	Trade has a large and robust impact on income, though statistical significance is slight.
Edwards	1998	Positive	Significant positive impact of openness on growth.
Sachs and Warner	1995	Positive	Authors introduce a Liberalization Index, and measure movement from closed to open trade regimes. Openness is strongly associated with growth in both developing and developed states.
Levin and Raut	1997	Positive	External liberalization propels growth through increased returns on scale and sectoral productivity.
Ben-David and Lowey	1998	Positive	Knowledge spillovers generated through trade raise income convergence and growth rates in the long run.
Gwartney et.al.	2000	Positive	Authors present an Index of Economic Freedom, which is positively correlated with economic growth and incomes per capita.
Badinger	2001	Positive	Trade liberalization and integration of the EU has increased growth across the region; GDP per capita would be one fifth lower in the absence of the common market.

Dollar and Kraay	2001	Positive	Increased trade leads to growth, poverty reduction, and economic convergence between states.
Rutherford and Tarr	2003	Positive	Reducing uniform tariffs drives stable and sustained increase in growth.
Rodriguez and Rodik	2001	Ambiguous	Review of trade literature concludes relationship between trade and growth is vague.
Esterly and Levine	2001	Likely positive	Trade regimes might affect growth, but complexity and inter-causality preclude precise correlation.

Certain authors have attempted to specify the exact impact of openness on economic growth, finding positive links between trade and growth. Furthermore, several studies have found that the effect of exports on economic growth are even greater in more developed countries – such as those of former Eastern Europe – than in poor, least-developed countries. Trade liberalization is more highly correlated with growth rates in middle income and developed states than in developing nations.

Table 5.2: Quantifying Impact of Trade on Growth

Authors	**Year**	**Impact**	**Key Findings**
Greenaway and Nam	1998	Positive	Liberalization has a positive impact on growth, though authors detect a lag. Strongly outward oriented states grow twice as fast as strongly inward oriented states.
Wacziarg and Welch	2008		Authors find a 2.55% difference in growth rates between liberalized and non-liberalized states during the 1990s; FDI is particularly vital to growth.

Table 5.3: Impact of Openness in Developed vs. Developing States

Author	**Year**	**Impact**	**Key Findings**
Michealy	1997	Positive for developed	Greater openness is positively correlated with growth in middle income or developed states; there is no correlation for developing states.
Kavoussi	1984	Positive for middle income	Spearman rank coefficient is significantly higher for middle income states than low income groups.

Kohli and Singh	1989	Positive	Outward and non-outward oriented countries both show a positive relationship between exports and growth, but the correlation is higher for outward states.
Moschos	1989	Positive	Openness has a higher impact on growth in low-income states, though the relationship is positive for middle income states.

Given the apparent strength of this relationship across multiple studies, trade liberalization has unsurprisingly been accepted as a vital component of prudent development. Edwards (1997) notes that between 1985 and 1995 almost 70 % of World Bank adjustment operations involved a component of trade liberalization, and typically required trade liberalization as a condition for lending. In support of this program, the World Bank also performed several major research programs that demonstrated the benefits of open economies over closed economies (e.g. Balassa, 1982; Feder, 1982; Papagoergiou et.al., 1991). These studies have generated findings that confirm the positive impact of general liberalization regimes on economic growth.

To determine the particular characteristics that have allowed certain states to implement successful trade and domestic liberalization agendas, in 1990, the World Bank (Papagoergiou et.al., 1991) undertook a comparative study of nineteen underdeveloped countries from Latin America, Asia and the Pacific, and the Mediterranean. Liberalization was defined as "starting with the introduction of some obvious elements of trade liberalization, and as ending either when these policies are reversed or when, alternatively, no further clear-cut measures of liberalization are undertaken." Using this criteria, the World Bank identified 38 liberalization episodes between 1950 and 1984, and nine countries that were able to maintain long-term liberalization. In examining the study, Papagoergiou et.al. (1991) observe the existence of a six year threshold. Namely, states that could sustain liberalization policies over the course of at least six years (which is presumably long enough to include at least one change of government) were most likely to be successful in permanently liberalizing their economies. Furthermore, successful states tended to be small, resource poor countries with stable political regimes, stable foreign exchange rates, smaller budgetary deficits, and higher export growth, whose liberalization was directly preceded by an economic crisis. At the start of the transition period, the Czech Republic, Slovakia, and Hungary all meet those criteria, and can thus be presumed to have possessed potential to carry out effective liberalization reforms.

In addition, certain components of the liberalization process have been shown to potentially suppress economic development. The first, and most critical of these domestic adjustments in an overall economic transition is price liberalization, which permits the establishment of the basic canons of market systems, and drives competition between firms. Research focused on the start of a transition period has raised questions about the possible negative effects of rapid price liberalization on inflation and thus domestic growth and standards of living (de Melo, Denzier and Gelb, 2001). Curiously, despite the wide differences in marketization across former Soviet Bloc countries, the formal degree of price liberalization was virtually uniform, somewhere around 80% for the states considered in this thesis. However, attempts to control rampant inflation led transition states to pursue further price liberalization along varying trajectories. As a result, most states chose to control prices in some key sectors – to differing degrees – throughout the decade. More recent research indicates that much of this early hesitation was unwarranted; although price liberalization had a negative effect on inflation at the start of the economy, it has not had adversely influenced the rate of inflation in the medium and short term (Hernandez-Cata, 1999).

Yet despite the abundance of studies linking economic liberalization and increase in GDP growth, the empirical literature comparing cross-country growth rates with liberalization has been critiqued for several reasons, including problems of measurement and the quality of data, endogeneity, causality, and the possible non-inclusion of other relevant policies. Firstly, as Rodriguez and Rodrik (2001) argue, the indicators of the degree of openness are vague and vacillating, and many are highly correlated with other variables related to poor economic performance. Quantifying non-tariff domestic protections is equally difficult (David, 2007). Secondly, determining a causal relationship between liberalization and growth has proved problematic, as states that experience growth may be more likely to pursue the opening of markets and trade (Andersen and Babula, 2008). Heightened firm performance and more competitive enterprises could be generated by any number of factors, and both contribute to, and depend on, strong economies. Finally, the positive impact of liberalization may in fact be underestimated: while a country may liberalize some aspects of its economy (such as external trade), it may have a number of other distortions, including price controls or labor market restrictions, that prevent the beneficial impact of exports from materializing (David, 2007). Still, studies that have attempted to control for the question of causality (e.g. Jung and Marshall, 1985; Dorado, 1993) have generally found that the promotion of liberalization indeed contributes to economic growth in most states; nonetheless, their findings have been significantly weaker.

Table 5.4: Problems of Causality

Authors	Year	Key Findings
Rodriguez and Rodik	2001	The relationship between trade and growth suffers from endogenity problems and confounding variables; indicators are vague and vacillating.
Andersen and Babula	2008	Causality between trade and growth is difficult to determine

David	2007	Impact of trade liberalization may be higher than studies capture because domestic distortions may not allow full beneficial effects.
Jung and Marshall	1985	Direction of impact between trade and growth is vague; in many instances, growth leads to greater liberalization.
Dorado	1993	Causality tests offer weak support that trade acts as a driver of growth.

In an attempt to answer these critiques, Wacziark and Welch (2008) consider country and time fixed-effects regressions of growth on the liberalization indicator in a global sample of 22 states, in order to isolate within-country variation, and find difference of 1.42% in growth between a liberalized and a non-liberalized regime between 1950 and 1998. They further demonstrate that countries that liberalized in the 1990s experienced a larger post-liberalization increase in growth than countries that liberalized in any other decade. Indeed, the estimated difference in growth during the 1990s is roughly 2.55%. However, the authors warn that the average results of these in-country variations mask differences in the individual responses of states to liberalization. In order to harness the positive effects of liberalization, states must adopt continued reform policies that emphasize macroeconomic stability and diminish protections for domestic sectors from adjustments.

The question of how a state chooses to pursue and pace these reforms persists. The relationship between the speed of economic liberalization and growth has been the subject of considerable controversy. Some economists have argued for advancing reforms in all areas as fast as possible; others have criticized such a strategy as imposing unnecessarily high social and economic costs (Roland, 2001). The sequencing of policies is likewise a matter on which there is little consensus: a state cannot effectively and concurrently target all economic, institutional and social reform programs. Advocates of rapid reform in amenable areas have argued that the synergies among different components, such as privatization undertaken together with liberalization of prices and trade, may generate enough gains and winners to maintain the reform momentum (Boycko, Shleifer and Vishny, 1995).

By contrast, promoters of slower reform emphasize that proceeding with “stroke of the pen” reforms that can be implemented quickly without prior establishment of time-consuming, yet fundamental modifications such as the creation of institutions that support market operations, significantly reduces the benefits of these reforms (Stiglitz, 2000). The loss could be so severe as to generate output losses and lead to the creation of interest groups and factions that prevent further progress. When the level of market rigidities is high, the costs of the transition to an open economy may undermine the credibility and popularity of the reforms. In such instances, the probability of the success of the liberalization may increase with a gradual approach to liberalizing the economy (Nsouli, Rached, and Funke, 2002).

The unfeasibility of merging different types of policy reforms into a single quantifiable, aggregate indicator precludes direct statistical cross-country analysis and eliminates the possibility of empirically demonstrating the optimal rate of progress along all dimensions of reform. Still, some conclusions can be inferred. A World Bank study finds (2001a) that annual output in is significantly linked with corresponding cumulative policy measures. Hence, more rapid and extensive pace of liberalization leads to prompter and more sustainable economic growth. Still, these findings only draw very general conclusions from the available data, and cannot necessarily be deployed in service of specific policy proposals. Reform policies account for more than half the variance in economic growth across Central and Eastern Europe in the transition period (World Bank, 2003); nevertheless, they leave several avenues for other variables that influence growth, namely country-specific indicators, external shocks, and individual national processes that will be analyzed and presented throughout this thesis.

Growth and economic policies in Central and Eastern Europe

The data over the last twenty years in the Czech Republic, Slovakia, and Hungary indicates a positive relationship between trade liberalization and economic growth. The initial conditions of geography, history, price and output distortions at the start of transition, the external economic shocks arising from the breakup of the Soviet Union, and the presence of civil strife have, of course, contributed to or deterred the post-transitional economic development of each state in Central and Eastern Europe. The evidence considered in this thesis indicates that policy reforms leading to economic liberalization and accompanying stabilization were critical for sustained post-transitional growth in Czech Republic, Slovakia, and Hungary, once differences in initial conditions and external economic shocks are accounted for. Market-oriented policy reforms not only sped up economic recovery and promoted growth in the medium term, but also mitigated the effects of the transitional recession in the short term. Finally, states that pursued faster and more comprehensive liberalization agendas were better poised to implement and maintain hard budget constraints, notably inflation, deficit and debt controls.

The ability of these states to effectively execute such economic reforms has principally depended on institutional characteristics of the political systems in transition, and how rapidly and effectively they divested control of key economic sectors from entrenched, elite factions. State sector employees often benefited little from the emergence of a competitive market; traditions of entrepreneurship, market operations and civic engagement are scarce; potential new entrants faced varying challenges and entry obstacles; and oligarchs and insiders inherited political influence and de facto control of state assets from the previous command system (World Bank, 2002b). Experience demonstrates that these short-term winners of partial reform can convert a small share of their gains into political influence that can be used to restrict entry, undermine competition, and preserve the very distortions that generate these rents (Hellman, 1998). These factions ultimately strive to secure liberalization without accompanying market reforms, channeling the benefits of open markets to specific groups over the long term. This can lead to a so-called partial reform paradox (World Bank, 2002b), whereby governments lack credibility to pursue restructuring, and are highly susceptible to state capture. Accordingly, in the opening stages of the transition, any new market entrants dismiss the pursuit of gains from sweeping and deep reform, and settle for partial reforms that carry lower initial entry costs, but eventually distorts market entry – so further pushing a cycle that entrenches early winners and arrests business support for market transformation.

Fundamental and drastic reform agendas hence require both government readiness and credibility to complete a long-term strategy, and collaboration from market participants. Public support reflects these conditions: in states that have been perceived as ineffective at enacting transition programs, or adopting measures beneficial to existing, powerful market and political forces, as in Hungary, public opinion quickly abandoned the argument toward liberalization.

The danger of "getting stuck" at a low level of reform, typified by liberalization without business restraint and truly competitive market environment (World Bank, 2002b), is present across all transition states. Restructuring state enterprises to compete in an open marketplace requires shedding protections, redundancies, and workers imbedded over decades of communist control. The onset of liberalization upsurges prices at the very moment it increases unemployment and reduces social protections and subsidized services. Many of the early individual “losers” of liberalization are unable recover such losses, or to adapt to a market system. In contrast, the gains associated with the policies of liberalization accrue primarily over the long term, as the institutions needed to promote entry and encourage competition – by securing property rights, vigilant contract enforcement, and providing good access to financing, among others – cannot be rapidly established. Yet only when liberalization and stabilization reforms are integrated into the economic system does the new market generate enough gains for enough agents to recompense some of these costs, or neutralize political opposition to reform.

Transition reform is thereby launched with a difficult paradox: individuals and firms must back policies that create instantaneous losses in order to achieve promised, if changeable and elusive, future gains. As transition success rests on continued public support, governments must persuade the public they can sustain and lead reform efforts through the “valley of transition” to the “higher hills” of stable, efficient market economies (Przeworski 1991, pg.138). This challenge may be particularly daunting in new democracies, where politicians are understandably reluctant to undertake radical economic reforms for fear of sparking public backlash (Hellman, 1998). Still, governments must motivate public trust in eventual gains stemming from the market system, rather than protectionist measures, and present these benefits as both attainable and widely accessible. Supporting the creation and expansion of new groups of beneficiaries of economic reform, by broadening the inclusion of citizens in the new democratic and market system, can thus bolster the stability and sustainability of a reform process (Haggard and Kaufman, 1995).

Additionally, dissimilar development strategies, trajectories and measures diverse combinations of economic, social, and political winners, giving rise to three distinct political imperatives. First, governments must obtain support for difficult reforms from new market entrants until the economy is stabilized and efficiency gains realized. Second, they must concurrently broaden this constituency by promoting an enthusiasm for entry into the new market environment, and concurrently. Third, they must impede insiders and oligarchs, commonly the early beneficiaries of liberalization and privatization schemes, from undermining or freezing reforms designed to harness market discipline and catalyze competition necessary to restructure and reorganize a more viable market economy.

This very problem of government credibility and checks is evident from the differing experiences of the Czech Republic, Slovakia, and Hungary. In the latter, a narrow group of elites guided both the central planning system, and the transition to new markets. The collapse of Hungarian communism was affected as much by external events and in-party disagreements as by a swelling of support for free enterprise. Emerging economic arrangements were devised by a transition government eager to tap into a wealth of gains to be derived from foreign interest in the newly opened market, yet reluctant to propose a politically challenging, if comprehensive reform plan. Indeed, early governments in Hungary began the process of transition without a general consensus on the paths or goals of reform, and lacking credibility to build and sustain far-reaching public support for liberalization and stabilization measures. The government pursued a piecemeal agenda of partial liberalization and privatization in the context of soft budgets that created vast pressures on the economy, and prevented the establishment of inclusive participation in the market culture. In Czechoslovakia, however, the dissolution of communist rule was spurred chiefly by a broad social movement. Governments were able to capitalize on early public enthusiasm to build a thorough program of economic reform including hard budget restraints, and continued to sustain support for the market system by offering broad and direct involvement in the new economy.

However, although early agents and political institutions driving the transition influence reform paths, these factors cannot wholly foreordain development paths in the highly intricate and multidimensional process of transition. Fernandez and Rodrik (1991) show that political economy analysis has an inherent status quo bias. Certainly, some skilled political leaders can build movements and mobilize constituents, broker agreements with opposing factions, and envision economic advancement of states. Moreover, as de Melo et.al. (2001) demonstrate, policies themselves are commonly endogenous, and may depend on initial conditions, including structure of reform leadership. They may henceforth be self-perpetuating: measures might be partly fixed by earlier policy decisions, and political choices might be constrained by existing institutions or expectations. Taken to an extreme, this view suggests that the advancement of transition states is bound by their leaders and institutions at the moment of transition.

Yet a closer examination of Central Europe highlights that states achieved economic growth where leaders followed specific measures or priorities. World Bank (2002b) data shows that, in the process of reform, gains and losses depend on the swiftness and scope of the first moves of liberalization and privatization. Sweeping agendas undoubtedly inflict greater initial adjustment costs on individuals and firms. Nonetheless, they may likewise cause fewer imbalances and distortions, and lead to faster and greater gains through the establishment of a functioning, effective, and competitive market economy. Conversely, less ambitious reform plans, marked by partial weak liberalization and privatization schemes, decelerate competition, economic growth, and market inclusion. Countries that exhibited strong and skilled leadership that focused on the four main areas of liberalization, privatization, creation of proper management rules and regulatory oversight, and mobilizing economic winners into pursuing new reforms have proven most successful in reaching and sustaining economic progress. Empirical literature (Dethier, Ghanem, and Zoli, 1999) reveals partial correlates between growth and policy reform. Cross-country evidence firmly suggests that policy reforms are strongly significant in determining output performance even when policies are treated as endogenous through a simultaneous equation model (de Melo et.al, 2001).

Initial conditions cannot be changed, or in many cases, influenced. Yet in any specific transition economy, resources can be deployed to realize several different priorities. Vested interests, insider holds, and monopoly power can be diffused by reforming political institutions, and transferring stewardship of the market to the private sector through privatization schemes. Liberalization can reject easy political or monetary gains from protectionism and instead follow hard budgets constraints. Such changes have accounted for the difference in the economic liberalization policies, and subsequent economic reforms, in Czech Republic, Slovakia and Hungary. In the latter, where the risk of oligarchs and insiders blocking anything more than partial reform was high, potential new entrants and state workers either rejected reform or supported only partial reform, because the latter, by limiting the downsizing of the state sector and maintaining the flow of subsidies, imposed lower correction costs. Over time, political and economic power has been used to preserve market distortions that benefit narrow vested interests at considerable social and economic cost. In contrast, in the Czech Republic, and, to an extent, Slovakia, rapid and inclusive liberalization and privatization played a crucial role in dispersing both the costs and benefits of the new economy, and bolstered public and state commitments to continuing the path of economic reform, so generating long-term conditions for economic growth.

Economic liberalization in Czechoslovakia

The Velvet revolution in Czechoslovakia was the result of a national movement demanding a complete economic shift from a centrally planned to open markets; the liberally oriented transitional government ushered in November 1989 so enjoyed a vast, if pressing, mandate to swiftly move toward dismantling the command economy. In January 1990, a freshly formed Economic Council met under the guidance of Vaclav Klaus with a directive to guide the Czechoslovakian government through its economic transition. The new Czechoslovakian government recognized that the establishment of a market economy and integration into Western trading networks would be critical to catalyzing economic growth (Froot and Sachs, 1994). Such liberalization and stabilization programs had to be executed in the shadow of the breakdown of the CMEA, and an overall decline in economic power among its traditional regional trading partners, where geographical and political repositioning and recession across the region depressed demand. In 1990, Czechoslovakia substantially devalued the koruna (Kcs) vis-à-vis the convertible currencies to ensure a highly competitive economy, and set a tightened budgetary surplus target of a 1-1.5 % (Dyba and Svejnar, 1994). Despite these precautionary measures, prices rose by 18.4% in 1990 after decades of stagnation under the Soviet system. The following year, Czechoslovakia's drift from managed CMEA trade to a free, global marketplace with liberalized prices severely damaged the national terms of trade by 22% during the first nine months of 1991.

At the onset of the transition, net material growth, a Soviet measure of growth in national accounts, declined precipitously, from 0.7% in 1989 to -19.5% in 1991 and into 1992, when the measure was abandoned. The decline was triggered by a massive deterioration of industrial production. The fall in the industrial sector was slightly more pronounced in Slovakia, at 24.9% to the Czech 22.5%; the reverse was true of the agriculture sector. Yet unlike NMP, Czechoslovakian GNP began to post growth in 1992, suggesting high growth in the service sector, particularly in comparison to other industries.

The Czechoslovakian transition teams quickly emphasized the need for a thorough and radical economic, political, and administrative transformation strategy. Precise policy recommendations in each sphere were enumerated (Svejnar, 1989), although internal negotiations regarding the pace and order of reforms spanned over several months. The most controversial disputes generally arose from administrative questions about the focus of economic power – unsurprising in a state emerging from a fully-centrally managed economy, and comprised of two inherently separate (Czech and Slovak) regions – and the division of economic authority and capability among various branches of the government (Dyba and Svejnar, 1994). Nonetheless, in 1990, the government formally proposed, and in 1991 ratified, a “Scenario of economic reform” to the Czechoslovakian Parliament, a comprehensive and specific plan of economic, social, and administrative restructuring bound by precise time parameters.

The deregulation of the Czechoslovakian economy, and its adaptation from a planned economy to an open market system, signified the first critical steps of building a stable, competitive and effective economic regime. At the start of 1991, the Czechoslovakian government inaugurated and began to implement the most extreme program of price, trade and enterprise liberalization in the former Soviet bloc. Interestingly, administrative and regulatory reform was not an oft-identified concern among liberal economists in the early 1990s (Aslund, 2002), who instead espoused a confidence in the spontaneous formation of markets in the absence of central planning. Nonetheless, Czechoslovakia moved swiftly towards external liberalization, which was viewed as vital to promoting market efficiency, competition and structural adjustments. The scarcity and high price of goods such as electronics and cars in particular created significant popular pressure for trade and import liberalization (Aslund, 2002).

As, Soviet states had no proper exchange rates, and pre-transition reforms across the former Eastern bloc introduced multiple exchange rates for various goods. In 1991, unified Czechoslovakian exchange rate was set near the parallel market rate to create a foundation for free foreign trade. The fast unification of the official exchange rate and subsequent convertibility of the koruna, coupled with trade liberalization led to unusually low levels of shadow economy in transitional Czechoslovakia, at approximately 13-14% of the GDP between 1990 and 1993, as compared to 22% for Central and Eastern Europe and nearly 33% for former Soviet states (Johnson et.al., 1997).

To better monitor transition in Europe, in 1991, the World Bank and EBRD introduced a Structural Reform Index, a synthetic indicator based on six weighted EBRD indices, normalized to reach a maximum score of 1 (where 30% is determined by price liberalization and competition, 30% by external liberalization, 13% by banking reform (together representing 73% of the index), and 27% by privatization. Empirical evidence suggests that states ranking below 0.5 on the index are nonmarket economies, while states that fall between 0.5 and 0.7 are intermediary market economies. Between 1990 and 1991, Czechoslovakia managed a drastic switch from a fully closed economy to an open market within the span of a single year.

Figure 5.1: Structural Reform Index

	1990	1991	1992
Czechoslovakia	0.16	0.79	0.86

Under such a dramatic transition regime, Czechoslovakia achieved a major structural transformation in foreign trade, as Germany replaced the USSR as Czechoslovakia's main trading partner, accounting for almost one-quarter of Czechoslovakia's foreign trade in 1992.

Figure 5.2: Share of Trade with the Soviet bloc

	1990	1991	1992
Czechoslovakia	60	50	40

OECD data similarly shows that Czechoslovak exports to OECD states grew continuously and significantly in the early years of the transition; imports from OECD states rose overall, but were subject to annual fluctuations due to declining domestic demand in some periods.

On the domestic front, the Scenario placed external liberalization in the context of a stabilization package based on strict management of inflation; other macroeconomic objectives, including growth and current and capital accounts, were deemed, within reason, secondary to anti-inflation targets. The government therefore proposed a series of canons, in addition to the aforementioned koruna convertibility, to support tight inflation targets, notably a restrictive monetary policy; a budget surplus equal to at least 2% of the GDP in 1991, respectively; and a positive real interest rate. Inflation presented a particular pressing concern across the region. In a true example of shock therapy 85% of all producer and consumer prices in Czechoslovakia were immediately released in January of 1991; a further liberalization of 10% of prices followed during the course of the year, leading to a dramatic rise in consumer prices of 53.6%. The decline in GDP was capped between 5% and 10%, in employment at an annual average of 4.5%, and in wages at 10%. The economy performed slightly below expectations across most indicators in 1991, yet by 1992, had met most stated objectives, as inflation rapidly fell (Figure 4.3) and the GDP began to grow in 1993 (Figure 4.1).

The initial transition shock drove up Czechoslovakia's moderate foreign debt early in the transition, as the state was forced to borrow funds from international organizations, including the IMF, the World Bank, and the European Community. But relatively stable budgets and increased foreign currency reserves, maintained stabilized debt levels by 1992 (Figure 4.5). The Scenario proposed that hard budget constraints be matched by additional microeconomic measures, including privatization of state owned enterprises; advanced liberalization of prices; an overhaul of the tax regime and the introduction of a value-added tax (VAT) in addition to a personal and corporate tax; budgetary improvements including institutional independence and transparency; labor restructuring and reductions; reformation of the social security and welfare systems with an aim toward reducing the share of government investment in social programs; limits on wage growth and legalization of collective bargaining; and an internally convertible koruna (Froot and Sachs, 1994).

To encourage private enterprise and new market entrants better regulatory and administrative support was extended to small and medium sized enterprises (SMEs). Commercial banks were slated for privatization, and the sector was endowed with autonomy and opened to competition. Bank credit to state firms was largely arrested, and credit to individual households was curbed; both rose in nominal but declined in real terms in 1991, before declining absolutely the following year. Conversely, bank credit to private sector firms rose from negligible amounts in 1990 to approximately 12% of the GDP – equivalent to funds slated for state enterprises – by 1991, before growing rapidly to 62% of the GDP in 1993 (Figure 4.14). Some of this extreme development between 1992 and 1993 can be attributed to the conversion of state firms to privately held companies.

Still, there were some early signs of economic deterioration by the mid-decade. The strength of the budget rested principally on revenues from initial high corporate income and profit taxes supported by a high profitability of goods in the immediate aftermath of price liberalization, and relatively low level of social expenditures, especially unemployment compensation (Dyba and Svejnar, 1994). As the transition shock depressed corporate profits, and the government introduced greater spending on education and healthcare, expenditures rose more rapidly than revenues, and the state posted a small deficit by the end of 1991 (Figure 4.6). Expenditures on unemployment did not reach the budget allocation, as employment figures remained higher than predicted. Unemployment was expected to rise to 4.5% with liberalization pressures, but remained well below the target through 1993 due to a lack of meaningful enterprise restructuring that persisted despite a heightened push toward privatization of large scale industries in the first wave (Figure 4.15). True unemployment figures perhaps only strengthen this argument. The Czechoslovak government estimated that approximately a third of individuals claiming unemployment status were either employed and seeking compensation benefits, or not actively pursuing work.

Some progress in the restructuring of firms had, in fact, clearly been achieved, both before and after the official start of large scale privatization schemes. While Czechoslovakia had posed a small growth in employment during the end of the Soviet era, the movement was quickly reversed with the announcement of the termination of a managed economy; and employment suddenly fell (Figure 4.15). Still, an overview of employment data reveals some troubling developments. Rates of production decline were not matched by a corresponding fall in employment, suggesting enterprises retained excessive workforces even in the face of falling output. Unemployment rates were markedly higher for young workers, and lowest for preretirement populations, implying a reluctance of enterprises to shed older workers and open spaces for new labor force entrants. Both trends were reversed by 1992, as production began to rise (Figure 4.11), and unemployment levels equalized between age groups, driven in part by a boom in the private sector. The reported fall in unemployment for 1992 may have moreover been in part the consequence of reduced unemployment eligibility and benefits introduced that year that certainly shrunk the rates of fictitious unemployment.

The years preceding the dissolution of Czechoslovakia witnessed a growing asymmetry in unemployment between the Czech Republic and Slovakia. Unemployment increased far quicker in the former, standing at 11.8% by the end of 1991, counter to 4.1% in the Czech Republic. The gap widened in early 1992, with opposed employment dynamics – unemployment rose in Slovakia, but fell in the Czech Republic. Such an incongruity within the indicator can chiefly be attributed to a stronger and earlier rise of the private sector in the Czech Republic, and better endurance of existing industrial production; and a more generous program of unemployment compensation and severance pay in Slovakia (Dyba and Svejnar, 1994). Employment issues in

Slovakia would dominate economic decisions made after its independence: public calls for employment protections delayed privatization, which in turn led to increasing pressure to further guard state enterprises in the interest of preserving employment. The joint Czechoslovakian government, however, mostly resisted such temptation to greatly loosen budgetary policy. Price liberalization was carried out without accompanying adjustments in wages; income increases remained under strict limits. Unemployment protections effectively served as the only real means of guarding living standards and household consumption, both of which nevertheless plummeted in 1991. Yet the Czechoslovakian government maintained that a focus on inflation constraints, a rise in production and exports – undoubtedly aided by low cost per worker – and stabilization of the economy would eventually exert positive pressures on growth.

With the economy strengthening by 1992, the government further decreased subsidies across particular protected sectors, most notably agriculture, and began to better define social expenditure projects and objectives. The Czechoslovakian attention to a restrictive economic policy did result in one particularly negative consequence, especially when combined with transition adjustments and external shocks. As focus was diverted to economic targets, the pace administrative reform did not match new market developments. Concerns about legislative and judicial protections lingered, particularly in the sphere of private property regulations. In an environment of ambiguous safeguards, poor domestic demand, and tight macroeconomic policies, firms slashed real investment by nearly 20% in 1991. Conservative monetary and fiscal agendas moreover encouraged reliance on inter-enterprise credit, which increased to 28% by the end of 1991, after matching total bank credit at 8.4% in 1990. This process shielded inefficient and illiquid state enterprises from declaring bankruptcy. The state was forced to recapitalize banks to reduce the debt levels of viable enterprises in preparation for privatization (Dyba and Svejnar, 1994), though this was true of businesses in every state in the region. The Czechoslovakian insistence on liberalization and stabilization, however, allowed the Czech Republic and Slovakia to embark on their independent development in 1993 with economies uniquely poised to engage in prudent and sustainable budgetary behavior that in turn led to stable and predictable market environments.

Economic Liberalization in the Czech Republic

During the post-transition period, the Czech Republic continued to build upon Czechoslovakia's radical set of liberalization reforms. The first Czech government, inaugurated in July, 1992, based its economic policy on three critical elements: creating a market economy through liberalization of prices, enterprises and trade, and the privatization of state assets; reducing the size of the government and balancing the budget; and achieving stability of currency a low inflation rate and a stable exchange rate.

Figure 5.3: Structural Reform Index

	1993	1995	1997	1999
Czech Republic	0.9	0.82	0.82	0.9

The Czech Republic was thus the first state in the former Soviet Bloc to reach a score of 0.9 on the World Bank EBRD structural reform index. The Heritage Foundation's Index of Economic Freedom (IEF) rated the Czech economy as moderately free, with a composite score in the high 60s on a scale from 0 (completely repressed) to 100 (fully free), throughout the transition period from 1995 through its accession to the European Union on the basis of indexes within the areas of rule of law, limited government, regulatory efficiency, and open markets (Figure 7.1).

Liberalization of trade and prices, rapid and widespread privatization of enterprise, and control of inflation received first priority; consolidation of assets, privatization of politically sensitive industries, and banking and regulatory reform would follow in the second half of the decade. Subsidies for industrial products were eliminated in 1991, while remaining controls for coal, gas and heating prices were further decreased or finally abolished by the 2001 Energy Act. The liberalization process did not initially cover areas such as housing, public transport, health and education in order to control inflation and reduce negative pressures on the domestic population; inflation peaked at in 1991, and the cumulative increase in the level of consumer prices during the first five years (1990 to 1995) of the new price regime as measured by the Consumer Price Index reached 138%. Price inflation dropped drastically by 1996, and has remained stable (Figure 4.3) and significantly lower than in many other post-Communist states. The Czech government began aligning prices of these remaining subsidized goods and services with their market levels in 1994, and the Czech National Bank estimated that most prices were aligned by 2000-2002. In 2001, the government abolished state regulation of rents. This massive price liberalization rapidly removed price distortions, revealing the relative scarcity of and demand for numerous goods.

External Liberalization

The Czech government identified participation in the free economic area of Europe and membership in the European Union as a central tenet of the state’s economic and foreign policy. Subsequent administrations continued to pursue EU membership and the reintegration of the

Czech Republic into the European manifold. In 1992, Prime Minister Klaus expressed that the chief objectives of his government would be “the quickest possible acquisition of full membership of the EU and NATO,” noting that he believed “the fulfillment of these goals to be the completion of [the] country’s transformation from the point of view of foreign policy” (Musil, 1992). The Czech Republic settled the Europe Association Agreement with the European Union in March, 1992. The Agreement, which entered into force in February, 1995, provided a framework for future discussions between the Czech Republic and the EU, created conditions for free trade between the state and the European Union, with some exceptions, principally in the sphere of agriculture, advanced economic relationships and technical and legal assistance, and implemented a roadmap for the gradual integration of the Czech Republic into the EU. In 1993, the Czech Republic became a member of the General Agreement on Tariffs and Trade (GATT), and has been a member of the World Trade Organization since 1995.

Trade with the European Union rose sharply in the post-transition period, in line with the gravity model that predicted Central European countries would drastically reorient their trade from the post-communist bloc to the West (Collins and Rodrik, 1991). The share of trade with non-transition countries as a percentage of total trade rose from 68.6% in 1994 to 73.9% in 1999. Between 1997 and 2006, over 90% of Czech merchandise exports were targeted at high-income countries. Predictably, the European Union emerged as the largest Czech trading partner, constituting 61% of all Czech foreign trade in 1997. The main categories of European Community exports to the Czech Republic in 2001 were heavy machinery and electrical goods, followed by transport equipment and base metals. The main Czech exports to the Community in the same year mirrored imports: heavy machinery and transport equipment, electrical goods, textiles, and base metals.

As a result of this reorientation to the West, the OECD ranked the Czech Republic as the most open of former Soviet states – and, indeed, among the most open countries in the world – in 1990, and again in 1997. In 1990, exports and imports together combined to 108.2% of the GDP, rising to 120.6% of the GDP in 1997, levels similar to those of the Netherlands and far surpassing the United States, Germany and Japan (Figure 4.17, Figure 4.18). The high ratios were bolstered by low exchange rates that depressed the Czech GDP in current dollars and low trade protections. In 1990, the Czechoslovakian tariff rate was 5.86%, and fell to 3.15% by Czech independence in 1993, driving exports (Figure 4.7). The World Bank rated the burden of customs procedures to be relatively effective throughout the 1990s, and the efficiency of the customs clearance process to be moderate; products generally required a handful of days to clear customs. Exports of goods and services, which measured 39% in 1992, crossed 60% of the GDP in 2000 (Figure 4.17). Unsurprisingly, manufacturing products account for the vast majority of Czech exports, and comprised 77% of all exported merchandise goods in 1993, and 89% in 2001. High tech exports have grown from 4.1% of all merchandise goods in 1993, to 14.5% in 2001. A similar trend is evident in the service industry, where 36% of commercial services exports in 2005 were in the field of computer and communication services. Agricultural products, metals and ores, and fuel exports contribute only marginally, with each amounting to less than 4% of total exported merchandise goods.

However, the Czech Republic, like most rapidly developing economies, suffered trade deficits during and after the transitional period. The opening of borders and movement of goods following the transition from a closed, Communist regime, led to a huge demand for European and foreign products and services. Imports grew by a staggering 29.7% in 1992, and continued to grow by more than 10% until 1997 (Figure 4.18). The influx of external goods coupled with relatively inefficient and uncompetitive domestic production sectors caused imports to rise significantly faster than exports, creating a negative balance of trade from 1994 to 2004 that contributed negatively to growth. The trade deficit coupled with strong domestic consumption as a share of the GDP resulted in a current account deficit that plagued the Czech Republic throughout the 1990s (Figure 4.6). The deficit, however, remained generally low, driven by a boom in consumption and investment that began to spill over into imports, and capital inflows (Begg, 1998). The Czech government attempted to address this imbalance by slightly raising tariffs in 1994 and 1995, before initiating a steep drop in rates in 1996.

Foreign Direct Investment

The Czech share of investment in GDP and foreign direct investment in the aftermath of the transition were relatively high, as compared to other Central and Eastern European countries. Investment was widely considered a principle objective of the transition across Central Europe, although IMF data shows that official net flows to transitioning countries from governments and inter-government agencies were in fact negative from 1993 to 1996. Nevertheless, the Czech Republic was able to attract some early capital from the private sector (Figure 4.8). As an early industrialized nation, the Czech Republic boasted a legacy of research and technological development, particularly in the field of mechanical engineering, that provided fertile ground for private investment. Nonetheless, Orenstein (2009) maintains that “foreign capital was at first weary of investing in post-Communist economies,” (pg.483) due to unpredictable markets and regulations, and untested economic relationships. A lack of foreign investment had contributed to a 15% contraction of the GDP between 1989 and 1992.

In order to further bolster additional foreign capital, in 1998, the government introduced a number of measures to catalyze investments by both domestic and foreign entities. Organizations or persons investing a minimum of ECU 22 million through a newly registered company in the Czech Republic received a 5-year direct tax holiday, duty free technological imports, the right to pursue duty-free zones, and subsidies for instruction and training of staff. Consequently, the Czech Republic proved remarkably able to attract foreign investment throughout the late 1990s (Figure 4.). The largest share of FDI came through Germany, the Netherlands and the United States. The improved investment climate, together with the privatization and diminishing role of large state conglomerates, greatly contributed to recovery from the 1997 financial crisis. Initially, the bulk of the investment was targeted towards the banking and infrastructure sectors, although investment in manufacturing firms accelerated toward the end of the decade. FDI has continued to progressively rise in absolute terms.

The rapid and continuing opening of the Czech Republic, both in terms of external liberalization, and introduction of competition into external markets, has been critical to its economic success over the past two decades. Undoubtedly, the liberalization shock therapy produced some economic losses, and led to reform hurdles in areas of administrative and legal branches. However, the shift of the economic stewardship from the central government to the free market was critical in allowing the economy to efficiently respond to market challenges and correct distortions and imbalances, as will be discussed in greater detail in the following chapter. The speed of liberalization reform prevented the entrenchment of certain factions or the continued concentration of real economic power within a small group of firms or individuals. The commitment to hard budget constrains – virtually impossible in the absence of liberalization – has generated a stable and foreseeable economic environment that has allowed for the development and advancement of market enterprises and an entrepreneurial culture.

Economic Liberalization in Slovakia

With the dissolution of Czechoslovakia, Slovakia found itself in an economically weaker position than its Czech counterpart. Despite a shared heritage of a centrally-planned economy, including similar labor market conditions, and price, wage and external liberalization shocks, the two Republics possessed deviating degrees of economic specialization and dynamism. Thus the impact of the transition was more pronounced, and the adjustment period markedly longer, in Slovakia. Sluggish growth, low productivity regions focused on agriculture, and noncompetitive, inefficient industries, including armaments and mining, were principally located in regions of Slovakia. Indeed, some divergence between the economies of the two states was apparent even before their separation. Notably, Slovak unemployment between 1990 and 1994 hovered at an average of just under 10.6% (Figure 4.15), and the budget deficit stood at 4.9% of the GDP (Figure 4.6), which fell by 22.1% in the same period (Figure 4.2). In comparison, in 1994, the Czech GDP experienced a 19.4% reduction, and the state faced a deficit of 0.3%.

This economic discrepancy was largely rooted in relative human capital resources: Czech Republic had both a slightly higher share of workers with higher education degrees (at 9.2% vs. 6.8%), and a significantly higher share of skilled blue collar workers, at 38.1% vs. Slovakia’s 19.7%. Moreover, while Czech lands were largely industrialized prior to WWII, virtually the entirety of the Slovak industry was built under the socialist regime. It was thus heavily dependent the import of cheap energy and raw materials from the Soviet Union, and deeply directed and shaped by the demands of the wider Soviet market: almost a quarter of the machine and electrical industry in Slovakia was based in arms production. By 1993, almost 50% of the available land in Slovakia was still devoted to agriculture, though it represented only 5.9% of value added to the GDP. Agricultural production fell sharply in the early 1990s, to barely 70% of its average output in the preceding decade. Consequently, the Czech economy was more resilient and better prepared for the international competition introduced after 1989 (Stroehlein et al., 1999).

Yet notwithstanding certain imbalances between Slovakia and the Czech Republic prior to the Velvet Divorce, much of the difference in their respective economic progress during and after the transition period can be traced to a shift in economic policies in Slovakia. Facing populist pressure to offset unemployment hardships and preserve control over the transfer of key industries to the private sectors, the first independent Slovak government under Vladimir Meciar largely abandoned the rigid and fast-paced reforms advocated by Klaus. Privatization efforts slowed considerably, and did not regain traction until the mid-1990s. More problematically, the state adopted a wide-reaching social safety net designed to offer wide ranging protections and benefits to the general population. Many liberalization efforts and processes were compromised in an effort to extend subsidies and protections to struggling industries in order to suppress potential rises in unemployment. Government spending was deployed in service of boosting the economy, and sustaining the socialist legacy of extensive social safety net programs. After its independence, Slovakia thus slowly transitioned to a full free market system, preserving state control or oversight in strategic industries and banks.

Subsidies were strengthened in the areas of agriculture, energy and transport, as was state aid to enterprises. Although prices had largely been liberalized prior to its independence, Slovakia slowed further liberalization in, and increased assistance to particular sectors. Consequently, Slovakia's inflation highs stood below those of its CEE counterparts; inflation peaked at 25.1% in 1993 and dropped dramatically to under 15% in 1994 (Figure 4.3). Distortions in prices are likewise evident in the Consumer Price Index, which registered an increase in prices of only 49.7% in 1993 despite the introduction of a value-added tax and the devaluation of the Slovak crown (Sk). Slovakia's wavering commitment to liberalization was evident in the drop of EBRD World Bank reform scores.

Figure 5.4: Structural Reform Index

	1993	**1995**	**1997**	**1998**
Slovakia	0.83	0.77	0.77	0.90

On the Index of Economic Freedom, Slovakia ranked as mostly unfree throughout the 1990s (Figure 7.1). Although economic growth in Slovakia was relatively high in the mid-1990s (Figure 4.1), it was achieved through partially unsustainable means. Between 1996 and 1998, current account of balance of payments deficits reached an average of 9%, and public finance deficits averaged almost 6%. Loose fiscal policy had to be counterbalanced by a tight monetary policy by the Central Bank, leading to an enormous rise in interest rates. As over borrowing and overspending by the government reached its zenith in 1999, GDP growth fell to a mere 1.3%.

In 1998 reforms, the Meciar government was replaced by a coalition government led by Mikolas Dzurinda, which almost immediately embarked on a series of sweeping economic reforms. In addition to reviving the privatization process, the government sought to complete liberalization toward a market economy and adopt a program of macroeconomic prudence, prioritizing the restructuring of the labor market, lowering taxes, and ensuring political stability. Railroads, the postal service, forestry and water services were the only industries sheltered from privatization. Slovakia implemented a range of thorough energy reforms over a short period of time with impressive results, decreasing energy subsidies by 2.48% between 2000 and 2003. In 2003, the government introduced new regulations aimed at eradicating price distortions in the energy sector caused by subsidies that generated artificially low prices divorced from real costs of energy production, supply and transition. In line with the new law, regulated prices were finally liberalized in 2007. In 1998, the first year of the reforms, the EBRD structural reform index increased Slovakia's progress to a score of 0.90.

External Liberalization

In a reversal of Czechoslovakia's determined pivot toward Western markets, newly independent Slovakia fell into regional and international isolation, and was frequently dubbed "the European black hole" (EU Commission, 2013). Although Slovakia was a founding member of the WTO, and performed the perfunctory application process for the European Association Agreement in 1995, trade with the Western market was relatively stagnant. The Slovak share of exports to and imports from the EU increased only slightly between 1994 and 1997 (Figure 4.17, Figure 4.18). The share of Slovakia's trade with its Central and Eastern European neighbors, excluding the Czech Republic, too, languished. Exports to the CEEC-10 increased from 10% in 1993 to 13% in 2000, and imports remained virtually unchanged, ranging from 5%-6% throughout this period.

Following its independence, Slovakia increased its average tariff rate from 4.1% in 1993 to 6.3% in 1996, before reducing it to under 4% by 1998. Still, Slovakia maintained rather high tariffs in certain industries in an attempt to protect their viability. Following the Uruguay Round, Slovakia introduced particularly high tariffs on certain agricultural goods, averaging 19% in the food and beverage sector. Unsurprisingly, in 1993, the total volume of foreign trade dropped by 7.3%, a decline that was recorded with all relevant regional blocks and trade partners, with the exception of Poland and Hungary. Trade over the following half decade proved erratic (Figure 4.17, Figure 4.18), though imports climbed higher than exports. The resulting negative balance of trade that plagued Slovakia for much of its transition decade suppressed potential growth. Slovakia has continued to struggle with a current accounts deficit that has averaged 4.3% from 1993 to 2015 (Figure 4.6).

However, with the shift of economic policy reforms under Dzurinda in 1998, Slovakia has slowly transformed itself into an economic and political regional leader. In 2000, Slovakia joined the OECD, and became a member of NATO and the European Union in 2004 and 2006, respectively. The share of total imports from the European Union reached almost 50% by 2002, rising by 36% in a single year between 1998 and 1999, while the share of Slovak exports to the EU rose to nearly 60%. As in the other CEECs, this export expansion was driven by foreign investment; companies with foreign capital exceeding 10% of their equity now account for well over half of Slovak exports and imports. As a result of this remarkable turn toward the European market, Slovak exports to the EU between 1993 and 2001 were second only to those of Estonia. Significant changes also occurred in specialization patterns: the share of transport equipment in exports to the EU rose from 9% to 31% between 1993 and 2001, and currently represent the largest sector of Slovak exports. Other sunrise industries of the 1990s were electric and non-electric machinery, all sectors buoyed by relatively inexpensive labor force with a medium to high degree of technical proficiency and capability.

By 2000, combined exports and imports had recovered to 110% of the GDP and have risen steadily. The average tariff rate in 2001 was lowered to approximately 2.3%, and continued to decrease as Slovakia began to prepare for EU accession. Exports have grown sharply while imports have fluctuated, allowing Slovakia to offset some of the Foreign Direct Investment capital streaming into the state through exports and a relatively favorable trade balance for much of the past two decades, with the noted exception of 2008. Indeed, Slovakia's extraordinary periods of growth between 2002 and 2007, and economic recovery since 2009, have been fueled by in great part by international trade and exports.

Foreign Direct Investment

Prior to 1998, Slovakia received little capital through direct foreign investments, especially when compared to its CEE counterparts. FDI rates between 1993 and 1998 averaged a mere 1.6% of the GDP (Figure 4.8). This figure can be attributed to preference for domestic capital in the privatization of companies – foreign investors were discouraged – and to a general lack of transparency in the rules and opportunities for investment. In 1998, the government began to modify investment regulations as they pertained to foreign entities by initially offering tax credits allowing exemptions from corporate income tax in particular activities. The incentive package was amended to create credits for creation of new employment positions, and to heavily promote the inflow of capital into industrial parks, with the state pledging to cover 70% of development of industrial parks by the municipalities. In fact, Slovakia's investment tax package at the turn of the millennium so favored large international corporations that the World Bank warned it could well prove to be destructive to firm competition and small firms, and narrow the tax base, increasing tax rates.

Yet the attractive investment climate, fostered by skilled but relatively cheap labor governed by a liberal labor regime; advantageous geographic location; and, most notably, low taxes consisting of a 19% flat tax for corporations and individuals, and no dividend taxes; propelled FDI inflows. By 2001, Slovakia had surpassed regional states in terms of FDI, with investments reaching 16.8% of the GDP (Figure 4.8). Investments have particularly targeted automotive, engineering and electronics industries. Foreign direct investment in Slovakia accounted for much of the growth between 2000 and 2008. FDI inflows, coupled with EU funding, finally made available with the state's impending accession to the Union in 2004, led to a sharp rise in productive capacities (Figure 4.9) and, accordingly, in real GDP (Figure 4.1). Although much of the investment was directed toward low-labor intensive new industries, growing economic strength and opportunity depressed the unemployment rate during the same time period to about 7.6% in 2008, the lowest point since the start of the transition. Inflation, too, declined to about 3% in 2008.

Slovakia hence presents an interesting counterpoint to the Czechoslovakian, and, later Czech, commitment to liberalization and hard budget constrains. Certainly, Slovakia faced unique challenges during its transition, including an economy far more burdened by unemployment, poor sectoral composition, and low productivity. However, it is not necessary to precisely compare Czech and Slovak development to detect the economic benefits that can be drawn from rapid and comprehensive liberalization and stabilization agendas. Where Slovakia abandoned such priorities in its transition trajectory, it suffered economic losses, both in comparison to the Czech Republic, and to its own previous economic condition. As an orientation toward hard budgets and Washington consensus priorities reemerged toward the latter part of the 1990s, Slovakia managed to position itself as a regional leader in terms of growth and rate of economic progress.

Liberalization in Hungary

In the decade and a half following the transition in Eastern Europe, Hungary was widely celebrated as regional leader of economic transformation from a communist to a free market economy. Relative to most of its former Soviet counterparts in the CEE, the country posted strong macroeconomic performance: GDP increased steadily between 1997 and 2001 at an annual average rate of 4.5% (Figure 4.2), unemployment fell continuously between1993 and 2003 (Figure 4.15), and labor productivity posted significantly higher growth than in other regional competitors (Figure 4.9). The praise for Hungary's rapid economic development during the first fifteen years after the transition largely focused on the state's ability to attract foreign interest and investment, and the strength of its export and manufacturing sectors. The apparent success of the Hungarian economy gave rise to a body of work that advocated gradual transformation efforts that emphasized the establishment support mechanisms for the private sector through institutional and regulatory reform in advance of abdicating control of the economy to the private sector through liberalization and privatization.

Yet from the start, the Hungarian economy displayed weaknesses that became evident in the aftermath of the 2008 financial crisis. In fact, considering the strength of its starting position vis-à-vis its neighbors in 1990, Hungary underperformed for much of its early transition period.

The initial economic contraction that enveloped the CEE in 1990 was particularly prolonged in Hungary, which did not achieve a positive growth rate until 1994. Notably, while the collapse in external demand that stemmed from the dissolution of CMEA was the predominant factor in the recession in Czechoslovakia, due to the relative liberalization of its economy during the 1980s, Hungary's share of CMEA trade was lowest in the region. Hungarian economic fall was instead driven principally by domestic reduction in investment in fixed capital and inventory (Valentinyi and Oblath, 1993), and a sharp drop in domestic consumption that suggested deep uncertainty about the outcome of the transition process. Certainly, the inability of the state to engage large segments of the population into the new economic system likely played a key role in this transition fatigue. Despite Hungary's recovery at mid-decade, spurred predominantly by privatization of state assets to foreign owners and an influx of foreign investment, the World Bank estimated the Hungarian economy as below potential until 2000.

Public perceptions of Hungary's transformation process within the country closely mirror this apprehension about its economic development. During the early and mid-1990s, comparative regional surveys depicted Hungarians as generally uneasy with the new market system: they were reported to be "most skeptical" about advantages of the market economy and "least supportive" of policies and institutions created arising from the shift to a free economy, as well as accordingly "most committed" to the values of socialism, and "most pessimistic" about future prospects (Mason, 1995). These findings did not achieved much attention, and were largely dismissed by both foreign and Hungarian analysts (Tokes, 1996). Presumably, Hungary's external openness and engagement with the Western markets, coupled with foreign interest in investment within Hungary, and the state's economic recovery starting at mid-decade assuaged such concerns.

Nevertheless, this public cynicism regarding the potential of the free market regime was both reflective of and contributed to Hungary's initial reluctance to adopt a strict economic transition plan, and to its more recent leaning toward a return to a managed, illiberal economic system.

Public doubt about the future of the transition process may well be traced to the lack of cohesive and comprehensive strategy that underlined the reform process in Hungary. Some liberalization efforts in Hungary had begun under a reform-oriented, and relatively autonomous communist regime in the 1980s. Pressure to democratize and establish a free market economy in Hungary was as much external as the cause of domestic movements. The transition was hence managed through a series of Round Table Talks in 1989 between these outgoing communist incumbents and opposition leaders and intellectuals with two main goals. Firstly, all parties committed to negotiating a full consensus on the strategy for Hungary's transition to a new political and economic environment. Secondly, they adopted specific modalities to solidify the emerging democratic and civic society, encompassing institutional restructuring; modifications to the Constitution; procedural safeguards for free and open elections; calm removal of former elites from public life; and public participation in civic and political life. Economic questions were deliberately excluded from consideration by the negotiating teams, and new elites did not raise an economic platform as a foundation, or raison d'être for a new liberal system. Unsurprisingly, therefore, the first free coalition government, elected in 1990 under Jozsef Antall, was unable – and unwilling – to reach compromise on any bold set of actions that might have spurred the economy or created any economic losses among segments of the population. Hungary thereby implemented a gradual program of liberalization without a strong commitment to a guiding economic principle. Although the EBRD marked Hungary as relatively advanced in terms of its transition progress, the score was heavily influenced by Hungary's foreign exchange and trade liberalization; price liberalization lagged well behind.

Market Liberalization

In contrast to other CEE states, Hungary began to implement some economic shifts in the decade preceding the transition. A legal framework recognizing private enterprise and beginning the process of moving state property into private ownership had been established. On the economic front, price liberalization formed the cornerstone of reforms undertaken by the Hungarian communist party during the 1980s. As a result, by 1990, approximately 80% of prices were at least partially liberalized; the share of subsidies in government expenditures were below 10%; and VAT and personal income tax had been introduced. The Hungarian tax base thus did not consist only of the profits of enterprise sector. Yet Hungary's hybrid price system led to unusual complications at the onset of the transition. Although the state imported energy and gas from CMEA trading partners at low rates, the cost of energy within Hungary closely matched Western market prices. The difference between import and domestic sale prices was collected as tax by the state; the elimination of devalued energy with the loss of Hungary's Eastern trading partners eradicated a significant source of income for the state.

The relative ease of price liberalization within Hungary allowed for somewhat moderate increase of inflation. Moreover, in the decade following the transition, Hungarian governments maintained sizeable subsidies on particular consumer goods including oil, food and housing. The annual average percentage change of the Consumer Price Index (CPI) never exceeded 40%, and rose above 30% only once, in 1991, as production subsidies were dropped. Disinflation fell steadily, if slowly, throughout the decade, with the exception of a 1995 surge caused by an excessive current account deficit and the adoption of a stabilization package (Figure 4.3). Despite structural advantages that allowed for inflation control, the Hungarian government did not pursue a tight anti-inflationary policy in the 1990s. By 2000, increases in oil and food prices, together with relatively loose monetary conditions caused by the crawling-peg regime, raised the average inflation above 10%. Finally faced with the pressure of meeting EU inflation standards in order to finalize accession, in 2001, the National Bank of Hungary (NBH) widened the exchange rate band, and assumed an inflation-targeting regime set at 3.5% to be achieved in 2004. The announcement quickly cut the inflation rate to approximately 9% in 2001. Yet prior to 2014, inflation never consistently met the EU targets; since then, Hungary has been experiencing persistent disinflation.

Initial inflation in the Czech Republic and Slovakia proved far more difficult to initially manage; both states experienced all a higher inflationary burst following price liberalization (56.6%, and 56.6% respectively). However, across the CEE, the initial eruption of inflation was not wholly undesirable. It eradicated debts bequeathed by the state planning systems that had been based on distorted prices and thereby backed by virtually worthless collateral (Wyplosz, 2000). Yet rising inflation tends to self-perpetuate and accelerate, particularly when monetary authorities are unwilling to refuse to ratify price increases, and governments cannot rely on independent Central Banks and debt financing to implement strict budget controls. In Hungary, the government proved reluctant to pass measures necessary to curb inflation: ratify price increases; effectively manage and reduce growing budget deficits; or adopt a rigid fixed exchange income regime.

For these reasons, Hungary displayed a rather slow reduction in the inflation rate as compared to Czechoslovakia and other advanced transitional economies that used the exchange rate and a more fixed exchange rate regime as a nominal anchor. Hungary, conversely, adopted a somewhat confused money-based inflation stabilization program that hoped to strike a balance between internal and external constraints through a fixed but adjustable exchange rate. The Central Bank sought to depress inflation through increased savings and lower domestic consumption. The restrictive monetary policy caused a considerable reduction in growth rates of monetary aggregates. Broad money (M3) growth declined from 35.7% in 1991 to 13% in 1994. Nonetheless, this monetary contraction did not effectively stem the rise of inflation. Devaluations were infrequent and insufficient, and the government failed to stabilize and control public spending. These deficits were in turn financed by foreign borrowing rather than monetary accommodation. However, the cost of this strategy was a larger external debt (Figure 4.5), and consequent pressure on foreign exchange earnings.

Hungary's internal liberalization experience suggests that cycles of increasingly harsher macroeconomic instability triggered by uncontrolled inflation and budget deficits can considerably advance the costs of the structural adjustment; significantly reduce options, whether political or economic, available to government agents; and destabilize reform agendas, particularly when reform is implemented through a gradual process susceptible to partial or incomplete realization and periodic challenges. Hence, repeated bouts of inflation can lead to the accumulation of inertial elements in the market, and fundamentally alter market expectations in a way that undermines reform. Exposing an economy to protracted periods of instability and uncertainty about the pace and course of reform has additionally proved detrimental to the development of entrepreneurial culture and, especially, the growth of a vibrant and resilient private sector (Rajaram, 1992). In Hungary, enterprise autonomy without financial discipline and with limited competition undermined the efficiency of the economy. In addition, issues related to ownership and the market for factors of production have not been adequately addressed. The Hungarian experience suggests that reforms during the first decade and a half were insufficient to allow the market to exercise a strong influence.

In 1995, as Hungary faced a fall in foreign investment, a trade deficit and a budget gap, a new government, elected in 1994, introduced a set of austerity measures referred to as the Bokoros package, after the Hungarian Minister of Finance. The cornerstones of the reforms ranged from the fiscal, including a single 9% devaluation of the Hungarian forint, and a constant sliding devaluation; to macroeconomic, with the introduction of an 8% additional customs duty on goods excluding energy sources; to social, particularly freezing growth of wages of public sector workers, cutting social expenditures and benefits, raising the retirement age of public administration employees, and eliminating free higher education. The tight fiscal measures achieved positive effects on the current account (Figure 4.6). Similarly, foreign debt dropped between 1994 and 1995, stabilizing between 50% and 60%. While the IMF and World Bank strongly backed the package, and Hungary’s economy began to showcase signs of recovery, the measures proved – and remain – deeply unpopular among public opinion, and the tight fiscal policy did not last. Despite a rise in FDI during the second half of the 1990s, the current account deficit increased (Figure 4.6). Buoyed by an inflow of foreign investment, the government nonetheless continuously raised levels of external debt. Shrinking FDI rates in the past decade have done little to dampen government debt.

Hungary has been classified by the OECD as a high tax and high spending country. In an experience that has been replicated across the CEE, as political and social structures and institutions became depended on sustenance through extensive public resources, subsequent governments find it increasingly difficult to suspend this pattern. The general government expenditures to GDP ratio fluctuated around 59% between 1992 and 1994; over the same period, they decreased from 50% to 41.8% in the Czech Republic and from 58% to 45.5% in Slovakia (Figure 4.4). The Bokros package brought about a significant reduction in the size of Hungarian government, though it remains high by international comparison. In 2000, average outlays to GDP ratio stood at 48.5% in Hungary, 44.8% in the Euro area, and 36.6% in the OECD. Hungary has been unable to further reduce expenditures.

Hungary's attempts to shield its population from negative effects of the transition was evident in its employment trends. Whereas unemployment in Czechoslovakia, and subsequently the Czech Republic and Slovakia, rose and accelerated in the second half of the 1990s, peaking in 1999, Hungary posted its highest rate of unemployment in 1992, at 11.9%. Unemployment dropped steadily until 2000 despite a reduction in labor force population (Figure 4.15). Conditions imposed on privatizing firms by the Hungarian government frequently prevented outright employee terminations, and instead favored early retirements. This has in turn placed enormous pressure on the Hungarian pension system, which was converted from a pay-as-you go scheme to a fully funded plan in 2003.

The stabilization program adopted in 1995 marked a clear change in Hungarian economic policy. The plan included a drastic revision of the exchange rate regime: Hungary adopted a crawling peg and began to announce both the timing and the size of devaluations, providing a clear nominal anchor for inflationary expectations. Monetary policy was not dramatically altered; Hungary continued to give precedence to the exchange rate over the monetary targets. Tighter fiscal policy additionally critically reduced the incentive to deficit monetization, contributing to improved inflationary expectations, and lower inflation rates. This approach was, however, shortly abandoned. In 2001, the National Bank of Hungary (NBH), in an attempt to end inflationary inertia ended exchange rate targeting in favor of an inflation targeting framework; the exchange rate band was concurrently widened from ±2.25% around the central parity against the Euro to ±15%. The Hungarian government recapitalized the state-owned banks prior to their privatization, setting a pattern for financial intermediation by the state. At the end of the 1990s, Hungary had a ratio of 46% of broad money (M3) to GDP, significantly smaller than that of Czech Republic at 75% and Slovakia at 65%.

The Bokoros package rapidly improved competitiveness, internal and external equilibrium and the debt service indicators of the country. The restrictive measures implemented under the stabilization program had costly economic and social consequences: namely an increase in inflation, a reduction in real wages (in 1995 and 1996) and a contraction in government spending. However, the stability displayed in subsequent years by the Hungarian economy provided a clear ex post justification for the stabilization program. The strength of the economy and the seeming soundness of economic reforms created a favorable environment for FDI which flowed steadily in the country since the beginning of transition, making Hungary the highest recipient of FDI (in per capita terms) of the region in the first two decades following the independence of CEE states.

External Liberalization

Hungary historic trade ties with Western Europe both before and during communist rule, made external liberalization a politically expedient process, even without a precise government accord on an overall transition strategy. Between 1991 and 1999, the share of trade in GDP grew dramatically (Figure 4.17), while the proportion of trade with non-transition states increased from 82.3% to 87.9% in the same period, highlighting in particular Hungary's trade networks with and rise of exports to Western Europe. Relative to domestic absorption, exports and imports mirrored growth rates (Figure 4.17, Figure 4.18). In line with a general global deceleration in trade, growth in exports and imports slowed and turned negative after 2001. Transition exports in the manufacturing sector to the EU were particularly strong, increasing by 195.9% between 1995 and 2000, the second highest rate among the CEE, allowing Hungary's trade balance to turn positive in 1999 and 2000. With the explosion of foreign trade, and a rise in tax rate on imports, tariffs revenue by 1995 equaled 12.9% of the value of all imports. Heightened liberalization efforts in the later stages of the transition substantially depressed tariffs to 2.4% of total value of imports by 1999.

This enormous growth in exports was fueled by two main factors: a fast rise in productivity, and low relative costs of labor. Indeed, Hungary's privatization of state enterprises to foreign owners catalyzed strong and efficient restructuring of firms under new management. The ensuing growth in productivity was hence the highest in the region, averaging 15.7% during the 1990s, more than double the rate of Czech Republic and Slovakia (Figure 4.9). Furthermore, international competitiveness was enormously boosted as real wages rose slower than in Hungary's regional counterparts, and lagged behind productivity growth between 1997 and 2005

– although actual nominal wage increases outpaced inflation throughout this period, excluding 1995 and 1996. Real unit labor costs therein fell by more than 50% in the second half of the decade, until 2001, while increasing by more than 30% in the Czech Republic.

Foreign Direct Investment

FDI orientation proved a crucial component of Hungary's transition and development. Empirical evidence for transition states demonstrates a strong correlational link between transition progress and FDI. Thus, the EBRD Transition Report (1998) shows a rank correlation coefficient of 0.89 between a state's average score on the EBRD transition indicators, and per capita FDI between 1989 and 1997: states that proceeded faster on the path to reform generally enjoyed higher rates of FDI. [Nonetheless, it should be noted that the EBRD's transition indicators ranked all three CEE states examined by this thesis as achieving the same rate of progress, despite both obvious and nuanced differenced in their development.] Foreign direct inflows to Hungary equaled more than 10% of the GDP in 1995 before dropping in the next ten years. FDI again spiked in 2007, at more than 50% of the GDP, but has since been particularly volatile (Figure 4.8). Reinvested profits were of similar magnitude, indicating that actual gross FDI was still higher than the reported cash figures. A major portion FDI inflows into Hungary during the transition period stemmed from privatization revenues that were commonly directed to the state. Data shows that, in 1995, privatization investments accounted for more than 50% of FDI on an accrual basis. By 1996, that share fell to 20% of FDI inflows by the following year. The contraction in privatization revenue is visible in the reduction of total FDI inflows prior to Hungary's accession to the EU – the loss of privatization revenue was not supplanted by other sources of investment.

Four factors played an important role in the attraction of FDI in Hungary: the privatization scheme that favored external owners and investors; low total labor costs; established historical networks and links with Western Europe; and the policy of incentives implemented by the government. Indeed, a distinguishing feature of Hungarian transformation strategy was the aggressive use of investment incentives. Free trade zones and industrial parks were established across the country, and attracted more than 100 corporations by 2001. Companies investing in disadvantaged regions were eligible, depending on the value of investment, for a credit on enterprise income tax ranging from 50% to 100% over a period of 5 to 10 years. Yet these measures were subject to two pointed criticisms: firstly, that the tax incentives were not entirely compatible with EU regulations and practices – in fact, many were dismantled upon accession; and secondly, that they unfairly advantaged large FDI firms at the expense of domestic SMEs.

FDI in general, and FDI generated by privatization of state-owned firms in particular, represented an important source of financing the fiscal deficit and repaying public debts, covering capital account deficits, and preventing economic crises (Kroska, 2001). The government did not feel it necessary to introduce a stabilization package marked by strict budgets, as excesses in spending could be effectively managed through incoming foreign capital. FDI firms (defined as having more than 10% foreign ownership) furthermore contributed to Hungary's export sector; the share of exports generated by FDI firms rose from The greatest from 54% in 1994 to 80% in 1999. A majority of corporate profits, both before and after tax, were likewise engendered by FDI firms. Cross country empirical evidence suggests that FDI is generally complementary as a source of financing to foreign credit and privatization revenues, although it acts as substitute of domestic credit (Kroska, 2001). Qualitative experience from Hungary, however, indicates that reliance on

FDI as budgetary foundation, may prevent the government from stabilizing and growing the domestic economy in a way that is sustainable through the long term, and through external shocks.

Yet, in the last decade and a half, Hungary has proved unable to maintain its competitive position. Well before the economic downturn that has characterized its economy since 2008, Hungary began to experience a steep reduction in investment inflows. As productivity growth waned after the initial restructuring of former state-owned enterprises and real wages accelerated in growth, Hungary has not matched the growth in foreign investment rates in the Czech Republic and Slovakia. Since 2005, for example, all Greenfield investments in the regional auto industry, which comprises a substantial portion of the Hungarian manufacturing sector, have been in the Czech Republic and Slovakia. This downturn in foreign investment has exposed some persistent structural weaknesses in the Hungarian economy that have effectively undermined growth since 2007. Most significantly, Hungary has been burdened by extremely high levels of public debt and a negative current account that has proven to be a drag on its growth potential. After failing to fully liberalize its markets during the first stages of the transition, the state has maintained high levels of social spending and protections as a means of ensuring political support despite budgetary. Evidence of this phenomenon appeared early in the transition period: Between 1993 and 1994, as the trade balance turned negative, FDI and capital inflows plummeted, and foreign debt increased (Figure 4.5).

Hungary's political reluctance to adopt full liberalization programs severely undermined the ability of the state to stabilize the economy, cut excessive spending and subsidies, and – as Chapter 7 will demonstrate – hindered the creation of an entrepreneurial environment conducive to innovation, participation, and new market entrants. Hungary became trapped in a condition of partial reform: as transition programs failed to generate expected market conditions, public support for reforms fell, and subsequent agendas became politically more difficult to enact. The failure to implement restrictive budgetary policy at the onset of the transition undermined the health of the economy, and created political pressures against any further cuts in expenditure. That Hungary succeeded in catalyzing economic growth during the 1990s cannot be taken as evidence of the strength of its economy, particularly given the economic developments over the last fifteen years. Instead, its early success can be attributed to a transition program sharply focused on growth through foreign direct investment as a panacea for domestic reform.

Summary

Long-term economic trends from the Czech Republic, Slovakia, and Hungary thus seem to vindicate the position that early and rapid liberalization that introduces market pressures onto both privatizing and new firms leads to more stable, and sustainable economic growth. Yet two new critical elements emerge from this discussion. Transition liberalization plans are dependent on two principal factors: the presence of a broad political consensus to move toward a free market, economic system, with at least a basic agreement on the process and steps of transition; and a willingness to assume certain political, social and economic costs in the short-term in order to implement transition proposals. However, this thesis demonstrates, realizing these factors depends on moving stewardship of the economy from the public to the private sector, and assuring public support for this development, even in the face of economic or social pressures. The form and scope of the privatization schemes considered in the next chapter, and whether they are able to engage public participation in the new market system, can be crucial in supporting the necessary economic measures of the transition.

CHAPTER 6: PRIVATIZATION

Privatization undoubtedly represents the cornerstone of state transformation programs; the relative success of economic transitions depends in large part on the ability of governments to successfully divert resources from inefficient, state-financed enterprises to the private sector (Blanchard, Froot and Sachs, 1994). As Nellis (1999) argues, the degree of privatization that has taken place in Central and Eastern European transition countries since their independence has been unparalleled: whereas roughly 6,800 medium and large scale firms were privatized under individual CEE central planning regimes between 1980 and 1991, close to 60,000 such companies were privatized in the transition economies during the 1990s. Additionally, the privatization of hundreds of thousands of small firms, and the establishment of an entrepreneurial sector through new market entrants, contributed to a momentous and swift change in the business ownership structure within transition states.

As central European states began their transition from centrally planned to free market economies, the privatization of state-owned enterprises (SOEs) was featured as possibly the most important element of the transformation, and vigorously debated in both academic research and popular writing. In the latter, privatization symbolized and embodied the very transformation from socialist to free market, capitalist ideology. In academic writings, privatization was presented as the spearhead of efforts to replace the hierarchical decisions of a command economy with the incentives of a profit-maximizing producer reacting to market signals – incentives that two centuries of pro-market economic theory largely concluded led to the optimal economic and social outcomes. As states adopted different methods of privatization, empirical research attempted to capture and clarify whether certain privatization schemes were more advantageous to growth in the transition period. The volume of literature on the subject is thus vast and diverse. However, significantly less attention has been devoted to Central European privatization since the end of the 1990s. Few studies have revisited earlier conclusions on the advantages and challenges of differing privatization schemes in light of newer economic trends, and there is virtually no analysis that attempts to discover whether certain forms of privatization created better conditions for economic growth in the long term.

Moreover, both the theory and practice of market economies assume the advantages of private versus public ownership to stem principally from pushing firms toward profit and productivity maximizing behavior. There is little empirical analysis on whether and how particular types of privatization affect a state's broader economic context. Do some types of privatization contribute not just to best-practice oriented behavior within firms, but to the construction of an institutional, legal or civic economic environment that is favorable for long-term growth? The following chapter will attend to precisely these questions in examining the privatization efforts of the Czech Republic, Slovakia and Hungary to find that rapid and inclusive privatization programs, namely the mass voucher scheme adopted in Czechoslovakia and subsequently the Czech Republic, played a critical role in assisting economic development. Although such a plan certainly had some negative consequences, it was critical in opening up broad support for the new market regime, and encouraging active, open, and inclusionary participation. Hungary, which adopted a program of direct sales to foreign investors enjoyed the early benefits of restructuring and FDI that followed. However, in the long term, the continued exclusion of individuals from the market and the entrepreneurial process created a number of harmful conditions: economic targets were set to favor large, foreign corporations; much of the population did not engage in the open market process; and financial discipline proved far harder to implement and sustain.

Review of privatization research

At the moment of their independence, Central European states were faced with an unusual predicament: the collapse of the Soviet regime had brought new confidence in the capitalist system, yet there was no workable theory to guide their process of transition. Some broad guidelines for a transition agenda were adopted by most states emerging from the Soviet umbrella. Komai (1994) highlighted two key preconditions necessary for a successful economic transformation toward market-oriented, profit maximizing behavior by all economic agents: driving a move from a sellers' to a buyers' market through price liberalization and enterprise restructuring; and enforcing hard budget constraints that eliminate various government support mechanisms. In the second stage of the transition, Blanchard (1997) added two dynamic elements critical to the ultimate success of privatization schemes: the reallocation of resources from old to new activities via closures and bankruptcies, combined with establishment of new enterprises; and restructuring within surviving firms via labor rationalization, product line change, and new investment. Nonetheless, the instruments that could be used to achieve these goals were not categorically specified. The last two decades have begun to yield new paradigms, yet still there has not been definite consensus on what speed and model of privatization is best suited to the creation of stable and efficient firms and economies.

Indeed, at the start of the 1990s, while scholars agreed that the ultimate goal of transition was the foundation of a vibrant private sector and efficiency improvements of firms that add up to aggregate growth of entire economies, they diverged on whether privatization was or should even be the primary mechanism for achieving these outcomes. One school of thought argued that privatization did not need to be pursued at the onset of the transition; although it did not deny the eventual need to privatize state assets, authors instead advocated the preeminence of implementing hard budgets to nurture a competitive market environment capable of driving restructuring through reallocation gains. The second school of thought maintained that rapid privatization must be the first step of a successful transition; other critical political and economic measures and reforms could be secondary to this process. Generally, this research focused on the effects of privatization on firm performance, which was assumed to have a complementary – and lasting – impact on the economy as a whole. As the process of transition continued, some authors adopted a revisionist sentiment and modified this second hypothesis to add that while in principle early and rapid privatization was beneficial, it did not automatically give rise to competitive conditions and market institutions irrespective of the method of privatization or presence of accompanying government efforts (Kikeri and Nellis, 2002).

Table 6.1: Pace and Sequencing of Privatization Reform

Authors	**Year**	**Pace of Privatization**	**Key Findings**
Frydman et.al.	1997	Gradual	Macroeconomic stabilization and hard budgets constraints coupled with low inflation, and price and trade liberalization, are sufficient to generate a competitive environment outside privatization.
Murrell	1992	Gradual	Focusing too deeply on privatization could divert resources and focus away from the more fundamental objective of encouraging new market entrants and de novo firms.

Barberis et.al.	1996	Rapid	Privatized enterprises will achieve greater restructuring and efficiency gains, as private owners directly shoulder the fiscal consequences of their actions, and are hence better motivated to raise products and productivity. Inversely, communist era insider agents of state enterprises were not selected based on meritocracy.
Kikeri and Nellis	2002	Rapid	Fast privatization is optimal, though it does not automatically lead to more competitive environments.

Thus, evaluating these two schools of thought requires disentangling the two questions they are concerned with. First, does privatization lead to firm-level efficiency improvements? Second, if these improvements exist, do they directly add up to country-level growth?

Empirical analyses of both developing and advanced industrial economies have shown that privatized firms outperform state-owned enterprises. In two formative papers, Vining and Boardman (1992) and Megginson et al. (1994) find a robust link between privatization and performance, as that privatized companies outpace state owned enterprises according to numerous performance standards. Frydman et al. (1997) advise that private ownership has the greatest impact on firm performance under conditions of uncertain external and market environments that exist across transition states. In such settings, developed entrepreneurial capability and knowledge, not commonly present in state-owned enterprises, are required to navigate the competitive landscape, and grow firms in the absence of clear market signals. State run firms, by contrast, are likely to be particularly unproductive and unresponsive to market trends, even if they operate in a (temporarily) open environment.

Nonetheless, evidence on whether the process of privatization leads to efficiency gains is mixed. The most complete investigation of the impact of privatization on firms (Djankov and Murrell, 2002) compiles the findings of more than 100 empirical studies of transition economies, and uses a meta-analysis of the results to generate overall conclusions and reveal patterns. Despite the plethora of material, the findings remain ambiguous, partly because the assessed studies employ a variety of data sets, measurements and methods that produce contradictory results. Commencing with productivity, and controlling for a range of variables, there is a wide variance in results across countries and samples, with private ownership found to yield positive, zero or negative effects depending on the studies included in the review. Sequencing is difficult to determine, as signals toward reliable and sound privatization plans can thereby be in and of themselves effective at forcing enterprise restructuring and more efficient firm performance. Finally, findings across the former Soviet bloc are often complicated and challenged by the highly visible and somewhat unusual case of Russia, which suffered a precipitous economic decline following a rapid privatization process, and continued to concentrate a significant portion of economic activity in privately owned yet unrestructured enterprises operating through the informal sector with the assistance of tax and wage arrears (Gaddy and Ickes, 1998). The Russian case, unique in many regards in terms of factors ranging from geography to historical legacy, certainly suggests that privatization alone cannot achieve sustainable economic and efficiency gains. An overview of major research on the effects of privatization on performance – and their somewhat confused conclusions – are presented in the table below.

Table 6.2: Impact of Privatization on Firm Performance

Authors	**Year**	**Impact of Privatization on Performance**	**Key Findings**
Djankov and Murrell	2002	Mixed	A review of empirical studies on privatization finds their conclusions vary, partially due to differences in methodology, indicators, and measurements.

Gaddy and Ickes	1998	Mixed	To be effective, privatization must be followed by restructuring that encompasses firm reductions in labor and changes in production output; as well as external shifts toward trade with advanced economies that together eventually lead to efficiency gains
Carlin et.al.	1995	No evidence	In an analysis of restructuring efforts of 450 state owned enterprises in Czechoslovakia, Hungary, Poland, and Russia between 1990 and 1993, Carlin et.al. find no significant evidence that privatized firms were more apt to restructure than their state-owned counterparts.
Pinto et.al.	1993	Ambiguous	Privatization may not be critical for efficiency gains, as Polish firms restructured without privatization.
Pinto and van Wijnbergen	1994	Secondary	Restructuring can stem from the liberalization or trade, and the state adoption of hard budget constraints. However, under such economic conditions, firms may reliably expect the eventual introduction of privatization schemes, and begin restructuring efforts in anticipation of such measures.
EBRD	1997	Secondary	The first phase of the transition in Central and Eastern European states was marked by defensive adjustments, including labor shedding and wage restraint, by both SOEs and privatized enterprises in preparation for the establishment of a competitive market economy. Defensive restructuring alone is not sufficient to achieve a sustained improvement in performance.
Aghion et.al.	1994	Insufficient	While privatization may be unnecessary, it is insufficient in prompting enterprise restructuring. They posit that such reforms were not closely linked to privatization in transition economies except in cases of sales to foreign ownership and the subsequent influx of outside management and capital.

Nevertheless, early studies on the impact of privatization, and its links to restructuring, appear to suffer from a common problem: privatization may take an undetermined and varying number of years to show sustained and stable benefits, and few states generally follow a linear, positive path of growth. In fact, empirical evidence drawn from the later stages of the transition has largely contested the idea that privatization did not play a critical role in enterprise readjustments and efficiency. Several more current analyses find that privatization is reliably linked with enhanced enterprise viability and performance under all competitive market conditions in transitioning states, albeit with differing degrees of impact. The summary of research that finds a positive relationship between privatization and performance. The sole major recent study that challenges this conclusion is likewise included.

Table 6.3: Positive Impact of Privatization on Performance

Authors	Year	Key Findings
Djankov and Pohl	1998	Privatization in 21 Slovakian firms is associated with an enhanced implementation of a number of restructuring measures, ranging from reductions in labor and capital stock, to the introduction of new products and markets, to heightened productivity and profitability.
Frydman et.al.	1997	Private ownership (with the noted exception of worker ownership) drastically improved firm performance and increased employment in the medium-sized companies in the Czech Republic, Hungary and Poland.
Pohl et.al.	1996	Privatization increases the likelihood of restructuring, as well as corporate productivity and profitability gains.
Belka et.al.	1995	Privatized firms outperform state enterprises in terms of restructuring, employment and efficiency, though they are in turn outperformed by de novo firms.
Earle et.al.	1998	Restructuring is more likely in privatized firms, even in states with contraversial privatization outcomes, such as Russia.
Barberis et.al.	1996	Privatized firms are more likely to have competent, efficiency-driven managers, even in Russia. They thus outperform state enterprises.
Pohl et.al.	1997	On average, four years after privatization, enterprises in the CEE posted productivity that was between 3 and 5 times higher than that of comparable state owned enterprises.
Smith et.al.	1997	In Slovenian firms, a 1% increase in foreign ownership added 3.9% value, while an equal rise in employee ownership added 1.4% value.
Djankov and Kreacic	1998	A close analysis of 96 Georgian manufacturing enterprises shows that privatization did not catalyze internal readjustments; import competition, however, has a measurable effect on improving corporate performance. The authors reconcile their findings with the general body of literature on privatization by raising the possibility that the Georgian market was particularly plagued by poor business practices, including a prevalence of insider owners and managers, and was thereby not encouraging of enterprise restructuring notwithstanding ownership type.

It should be noted that most of the summarized studies have accounted for the statistically critical issue of selection bias that appears when firms are targeted for privatization by state administrations based on their existing superiority and aptitude for the private sector, whilst poor performers remain under state ownership. Some authors [including Barberis et.al. (1996), Smith et.al. (1997), and Earle and Estrin (1996)] neutralize and protect against selection bias through statistical channels, instrumental variable methods. Others, notably Frydman et.al. (1997), contrast the performance of state owned enterprises with private businesses both before and after the realization of their privatization process. Thus, even when allowing for the possibility that better and more competitive firms are privatized ahead of weak or inefficient state owned enterprises, data reveals that privatization is indeed associated with stronger performance.

Contemporary research hence largely suggests that privatization leads to efficiency gains for firms, primarily through the process of restructuring. The interdependence of the market environment and privatization demonstrated by Djankov and Kreacic (1998) may be broadened to explain the differences in results regarding the importance of privatization on firm restructuring and performance from studies in the early and later years of the transition. The rise of a market economy could have prompted initial restructuring even within state owned firms. Yet as the transition deepened, lingering inefficiencies in SOEs now operating in a competitive, open market may have become exacerbated, and such firms may have been unwilling to complete the necessary steps of restructuring, contributing to acute differences between private and state owned firms. Still, evidence on whether and how firm-level efficiency gains aggregate or contribute to overall GDP growth – and, accordingly, whether and how privatization leads to economy-wide growth – is mixed. Some studies find a positive relationship between the share of private sector activity, and an economy’s overall health and growth, while others reach the opposing conclusion.

Table 6.4: Impact of Privatization on Economic Growth

Author	Year	Impact of Privatization on Growth	Key Findings
Havrylyshyn et.al.	1998	Significant, positive	Privatization has a significant and positive effect on growth across twenty five states of the former Soviet bloc between the EBRD's synthetic measures for restructuring and privatization.
IMF	1997	Significant, positive	post-Socialist European states that maintained economic growth for more than three years between 1990 and 1998 enjoyed a proportion of private sector activity that exceeded 60% in the CEE and Baltics, and surpassed 55% in the CIS. States that posted only one or two years of growth had private sector shares of 50% and 44% in the CEE and Baltics, and the CIS, respectively. CIS countries that did not achieve a single year of growth correspondingly had the lowest proportion of private sector activity, at only 38%.
Plane	1997	Positive	In a global sample of thirty-five developing countries in transition that controls for the problem of reverse causality by identifying the specific factors that generate a successful privatization program, empirical evidence shows that the impact of privatization on economic growth is indeed positive and significant, and is particularly apparent when privatization occurs in infrastructure or industrial sectors.
Sachs, Zinnes and Eilat	2001	No association	An aggregate growth regression for former Soviet transition states concludes that privatization does not actually drive a rise growth. However, when privatization is undertaken in the context of institutional, legal and administrative reforms, and hard budget restraints, it yields a positive effect on growth.
Bennett et.al.	2007	No association	In all European transition economies, there is no significant association between growth and proportion of economic activity held in the private sector, thus dismissing a direct link between privatization and economic growth.

Further complicating the ambiguity of empirical findings is that several studies present caveats or exceptions to their own conclusions. Authors who find no relationship between privatization and economic performance do not extend their analysis to demonstrate whether privatization itself may indirectly lead or contribute to institutional reforms and hard budgets that drive growth. Nevertheless, even the IMF (1998) study identifies a number of dramatic cases where privatization was not connected to growth, including four states that suffered reversals of growth despite private sector shares averaging 65%: Bulgaria and Romania in l996-1997 (though Bulgarian growth resumed again in 1998), Russia since 1998, and Czech Republic in 1998 after five years of uneven growth. However, two important points must be acknowledged in light of this supposition. Firstly, confining the positive effects of privatization merely on firm performance and efficiency disregards the plethora of impacts the process of privatization may have on state agencies, institutions, cultural norms, and business practices that, in turn, foster economic stability and growth. The difficulty of assigning quantifiable value to privatization and firm performance may undermine attempts to broaden the search for influences of privatization on state institutions and the economy. A detailed analysis of relevant cases may hence be crucial to revealing these hidden or indirect trends. Secondly, privatization itself may follow divergent paths. While one form or pace of privatization may yield positive effects on economic growth, improperly designed and implemented privatization may well lead to underperforming firm and economic systems.

Selection of privatization method

The privatization of centrally planned economies commonly follows one or a combination of five common channels: restitution, case-by-case direct sales and equity offerings, management buyouts, employee buyouts, and mass privatization (Havrylyshyn and McGettigan, 1999b). Restitution played a very small role in initial Czech privatization, but was not prominent in Central Europe; the relative merits of the other methods in these and other transition economies were widely analyzed. The key factor in ascertaining the most favorable method of privatization is typically drawn from industrial organization theory, and is defined as optimizing efficiency gains in light of the "agency" problem: owners cannot necessarily serve as firm managers, and agents are expected to reflect and prioritize the owners' objective of maximizing shareholder profits. Frydman et al. (1997) offer a typical example of academic literature on the agency problem in transition economies, presenting a commonly held view that outside governance mechanisms that promote efficacy – whether professional and independent boards of directors, external competition, or strong securities markets – are largely absent or in their nascent stages in these states. Conditions for growth must thereby be generated from within firms themselves, and it follows that best privatization schemes establish direct oversight by owners and professional managers with proven experience. While this does not necessarily imply the supremacy of one system, it does suggest that the most effective privatization method might be direct sales and equity offers to outsiders (including foreigners), and possibly management buyouts, rather than worker buyouts or mass privatization.

Yet the selection of a privatization program was on occasion predetermined not by a state's economic agents, but by its economic circumstances. Emerging administrative structures were generally ill-equipped to prepare and value individual firms for privatization, and to manage the complex and long process of privatization. The viability of a particular privatization scheme was uniquely complicated by a number of political and economic influences in each state (Boycko, 1994; Lewandowski, 1997). A shortage of private wealth concentration – a common legacy of socialism – could preclude direct sales to domestic agents; weak foreign investor interest and confidence, and poor quality and accessibility of accurate enterprise information could prevent external sales; and the political dissatisfaction regarding the concentration of capital and assets with limited number of owners and investors could block direct sales.

Given such constraints, Gray (1996) shows that due to initial weaknesses of domestic capital markets, direct sales and equity offerings, particularly to foreign investors, were the favored method of privatization of most domestic decision-makers at the start of the transition. Beyond mere feasibility and capacity to inject capital into newly privatized firms, external owners were expected to increase performance and revenue earnings, and introduce models of corporate governance. Boycko et.al. (1994) argued that this approach would additionally ensure the greatest transparency and value of transactions, since state assets would be transferred according to the highest offer. Equity offerings, however, were to be externally virtually unachievable in transition democracies given the underdeveloped domestic stock markets and weak foreign interest. Direct sales were frequently internally disrupted, as existing shareholders and insiders, including workers and managers, prevented the realization of such privatizations (Pohl et.al, 1996). Hungary hence remains a rare example of privatization through the use of direct sales by a transitioning state.

Due to the practical and political restraints on direct or equity sales, some scholars have argue that effective privatization and eventual efficiency gains are best accomplished through management-employee buyouts. Such a scheme, wherein shares of enterprises are sold or donated to some combination of managers and employees, was particularly attractive in states with socialist legacies of employee syndicate “ownership” of corporations. Lipton and Sachs (1992) emphasize that manager and worker buyouts eliminate internal opposition to transfer of enterprise shares. Yet in practice, empirical evidence shows that such an emphasis on worker preferences, granted by management-employee buyouts, results in efficiency losses and poor corporate governance (Gray, 1996). An IMF overview of literature on labor-managed firms establishes that firms dominated by insiders are more likely to confer excessive wage increases and maintain over-employment, and are less likely to devote resources to research and investment (Havrylyshryn and McGettigan, 1999b). IMF empirical evidence likewise suggests that socialist-era insiders may lack skills necessary to compete in a market economy. Consequently, Earle and Estrin (1996) demonstrate that insider ownership tends to gradually and naturally move toward investor ownership in advanced industrialized economies. In transition economies, however, insiders frequently hinder the entry of new investors and manages, and outside participation (Gray, 1996). This paradox presents a complex challenge of privatization in states where employees hold substantial management power prior to the transition: management-buyouts may be the only realistically workable path to privatization; yet that scheme will likely contribute both employee empowerment and falling efficiency and performance, limiting options for states and managers to pursue new sources of capital, or new forms of expenditure reductions.

Emerging CEE economies thus had to both address the shortage of preferred mechanisms of privatization, namely domestic capital and foreign investor interest, and manage competing political pressures from existing stakeholders. Because of the potential shortcomings of both direct sales and internal buy-outs, some states introduced a relatively novel system of voucher-based mass privatization that had previously been rarely deployed. Mass privatization can be rapid and politically advantageous: it can outpace the formation of opposition groups seeking to arrest or decelerate privatization (Lipton and Sachs, 1992); avoid charges of sales of national assets to foreigners; and allow for broad inclusion and ownership in the new private sector (Lieberman et.al., 1995). Furthermore, such a scheme could have wider implications on the entire reform agenda. Lipton and Sachs (1992) reasoned that the swift execution of privatization programs can contribute credibility to the transformation processes, creating interactive spill-overs to other areas slated for reform. So too, can the inclusive and broad participation of individuals in the new market system generate public support for the reform process, and aid in the encouragement of new market entrants, a culture of entrepreneurship, and accompanying capital market institutions.

In a cross country study of Central and Eastern Europe, Bennett et.al. (2007) find that voucher privatization has been associated with faster macroeconomic growth; states that deployed mass privatization schemes posted enjoyed significantly a greater increase in growth rates as compared with the pre-privatization period than states which utilized other methods of transferring state firms to private ownership. Miller and Lazarov (2011) support this finding in a study that shows that firms that were privatized through mass privatization schemes have performed better than their counterparts privatized through direct sales and buyouts – while such firms may initially struggle, over the long term, they prove to be 20% more asset productive and 8% more cost efficient. Even within single states this conclusion appears valid: Miller and Petranov (2003) demonstrate that Bulgarian firms privatized through the voucher program that led to dispersed or fund ownership performed better than firms controlled by management and employees.

On the other hand, critics of mass privatization programs held that this rapid process was deeply subject to agency problems as laid out by Frydman (1997): diffused ownership may be unequipped to follow best practices of corporate governance, or pursue an optimal development and growth firm strategy. Additionally, while the rapid pace of progress may prevent the partial reform trap, it does not allow for the development and advancement of accompanying institutions, legal frameworks, and property and investor protections needed to protect and secure the competitive market (Lieberman, 1995). Accordingly, Gouret (2007) finds after accounting for effects of macroeconomic stabilization and reform policies, domestic gains in growth come are achieved only through gradual privatization, which precludes the mass voucher program. Yet Gouret does not address the possibility that the very benefits of rapid privatization programs might be in their positive influence on stabilization and reform agendas that are lost in his statistical model. Indeed, research has generally not attempted to elucidate a possible connection between forms of privatization programs and success of long-term reform.

The weakness of legal protections for individual shareholders has often been mitigated, at least in part, by concentrating ownership shares in investment or mutual funds established to accompany a mass privatization program, or in response to difficulties of dispersed ownership. In the Czech Republic, ownership pooled into a small number of such investment funds in a wave of “third privatization” (Pohl et.al, 1997), and initial mass ownership patterns were fundamentally transformed to outcomes more akin to those of direct sales within a short period of time. The performance of these funds has been the subject of much debate, most notably within the Czech example, and across Central and Eastern Europe. On the cusp of the financial crisis in the Czech Republic, Frydman et.al. (1997) presented evidence that funds are linked with robust firm performance. Subsequently, Mertlick (1997), Uvalic and Vaughan-Whitehead (1997) and Ellerman (1998) have criticized the funds as lacking effective management and proper supervisory oversight, and evidence from the Czech experience in the mid-1990s has certainly led credence to doubts over the effectiveness and desirability of these investment mutual funds – and, by extension, voucher privatization. No noted empirical study has focused on fund performance since this period; tangentially, Miller and Lazarov (2011) hold that higher ownership concentration in privatized firms has been associated with better performance.

Effectiveness of privatization models

A wealth of empirical work compares the relative efficacy of insider (that is, buy-out driven) and outsider (mass privatization driven) ownership in a transition context. The results have generally indicated the advantage of external ownership, though results are mixed and at times contradictory.

Table 6.5: Forms of Privatization and Firm Performance

Author	**Year**	**Optimal Privatization Model**	**Key Findings**
Earle et.al.	1996	None	A review of Russian firm performance found no difference in efficiency based on ownership type. Russian privatization was channeled principally through insider buyouts, and was driven by political rather than market factors, which may have impacted the findings
Lipton and Sachs	1992	Outside ownership	Insider ownership of firms could lead to a continuation of standing inefficiencies.
Aghion et.al.	1994	Outside ownership	Insider privatization did not give rise to substantial restructuring.
Frydman et.al.	1997	Outside domestic or foreign ownership; managerial ownership	Significant variances in corporate performance according to ownership type, wherein externally-owned enterprises outperformed state-controlled structures across a range of indicators, including revenue and employment, with revenue performance of firms with foreign owners equivalent to that of firms owned by domestic outsiders. Managerial firms in turn outperformed employee-owned companies.
Claessens and Djankov	1997	Outside ownership	External ownership concentration among Czech enterprises is associated with a rise in restructuring, and, consequently, productivity and profitability.
Smith et.al.	1997	Foreign outside ownership	Foreign owned firms outpeformed domestically owned counterparts; such an ownership structure may not be achievable through buy-outs.
Shleifer and Vishny	1997	Outside ownership	Firms with more concentrated outsider ownership structures perform better companies with a dispersed ownership structure due to stronger application of proper corporate governance.

Djankov	1999	Managerial ownership	Managed firms demonstrated a visible growth in revenue performance, though they similarly resisted reductions in employment and expenditures.
Djankov and Pohl	1998	Ambiguous	Insider privatization of Slovak firms did not obstruct restructuring in the short term.
Djankov and Murrell	2002	Investment funds, foreign outside ownership	Both investment funds and foreign ownership produce restructuring 50% greater than in insider owned firms. However, there is almost no evidence that company performance is improved when firms are privatized to insiders, either managers or workers.

On balance, despite some mixed evidence, and the narrowness of the set of countries that have been studied, a consensus view from empirical studies is emerging: no method of privatization has been unambiguously demonstrated as superior to others. However, it also appears that insider privatization and worker dominated schemes have generally led to poorer firm performance, and de nova firms, as opposed to recently privatized firms, when included in the study, invariably show better performance than any existing privatized enterprises. The question of whether rapid privatization is preferable to a more gradual process remains unanswered. The only two clear cases of such privatization, the Czech Republic and Russia, have yielded vastly divergent results, although both suffered significant setbacks and challenges related to corporate governance. Yet where Russia perpetuated insider ownership of former state enterprises, the Czech system introduced outside and broadly inclusive private sector ownership.

Part of the opacity appears to stem from the difficulty in separating variables – better economic performance and hard budgets are correlated with improved firm performance; yet there is little empirical attention, outside of Lipton and Sachs in 1992, devoted to the question of how privatization may affect these economic steps. Notwithstanding the research and findings on varying forms of privatization methods, if a country is to advance stable and sustainable market development, it must both empower the private sector through an effective privatization scheme, and build a market environment supportive of private enterprise. The continued success of each factor undoubtedly affects success of the other: as effective and autonomous private firms drive the continued improvement of the market and its supporting administrative and political context, so does market stability and predictability generate space for the growth of enterprise. The importance of proper sequencing and form of these measures at the moment of transition, however, has not been settled, and two opposing viewpoints persist: the first emphasizes the need for competitive and effective markets that determine the eventual success of privatization programs regardless of their system; the second holds that the proper selection of a privatization regime launched in concurrence with market creation can positively influence market and economic processes (Havrylyshyn and McGettigan, 1999b).

Literature has not shed much light on this opposition, and the question has not been studied empirically. Ganiev (1997) is a rare exception: he finds that transforming the market environment and introducing stability and discipline has greater bearing on market efficiency, though he admits to problems of endogeneity and multicollinearity. If privatization transfers enough stewardship of the economy to the private sector, state institutions may find it easier to implement particular reforms. Additionally, if privatization produces broad participation of a state's citizenry in the market system, it may lead to the creation of more stable and lasting market reforms. It may thereby be prudent to examine the process of privatization in various states in order to illuminate its interdependent and dynamic effects on the general economy.

To build a market environment that can accommodate long-term growth, in addition to transferring ownership of formerly state controlled enterprises to private actors, privatization must create conditions conducive to the establishment of de novo private firms and SMEs that are among the main engines of economic growth in transition states (EBRD, 1997). The mechanisms through which such firms drive growth are considered by Earle and Estrin (1997), Murrell (1992), and Richter and Schaffer (1996), and include the introduction of new actors, skills, innovation, and ideas into the private sector. Yet the success of such firms may well depend on privatization of existing enterprises; the availability of assets, human capital, and availability of investment and credit rests in large part on their release from inefficient state enterprises (Earle and Estrin, 1997). If privatization encourages a mass buy-in into the private sector, it may spur a culture of entrepreneurship that can extend to the establishment of new firms. A public inclusion into the market system may normalize the ownership of small and medium enterprises by private agents, and so lead to a willingness to engage in entrepreneurial risk. However, the effects of modes of privatization on the creation of de novo firms has not been empirically examined. The importance of such new market entrants, and their relative role in the development of entrepreneurial sectors in the CEE, will be considered further in Chapter 7.

Privatization in Central and Eastern Europe

Thus, as shown, existing research has failed to provide conclusive answers as to the significance of the role of privatization and the mode of privatization to economic growth. Some board inferences may be drawn from a review of the data: privatization does appear to have some positive impact on firm performance and economic growth, although there are reservations about the ability of privatization to drive economic growth in the absence of a favorable market environment. Some authors have argued that privatization may be secondary to essential market forces, namely, macroeconomic stability, hard budget constraints, competitive markets, and adequate property rights. Yet, they have not empirically considered whether successful privatization may influence or ease the achievement of these market factors. Research has, for the most part, demonstrated that privatization to outsiders, whether foreign or domestic, is preferable to insider buy-outs, although little has been done to conclusively determine which form and speed of privatization carries more beneficial long term effects. The vagueness of empirical results is clearly evident in the case of Central and Eastern Europe: In the late 1990s, the Hungarian model of foreign ownership was hailed as vastly superior to the Czech mass privatization scheme that fell victim to an inadequate regulatory framework. Twenty years later, the respective economies of Hungary and the Czech Republic shed doubt on, and reverse this verdict.

Indeed, the privatization efforts in the Czech Republic, Slovakia, and Hungary suggest that much of the debate regarding the relative importance of the speed or method of privatization is rather misguided. The ultimate goals of privatization go beyond simple ownership transformation and firm efficacy and governance. Rather, they must include increasing public support for the privatization and transformation process, which strips many protections of a communist regime, and the foundation of a vibrant, domestic private sector. At the start of the 1990s, the newly independent states of East and South Europe found themselves without prescribed transition mechanisms. Although global economists and institutions advocated swift conversion to free market systems through liberalization and privatization, each country in the region pursued its own transitional trajectory with varying degrees of success. Privatization schemes in particular differed greatly in regard to their pace, intensity and organization; some were preceded by regulatory and bank reforms, while others were positioned as the first step of reform. All such efforts were marked by differing degrees of setbacks and issues, from poor managerial and firm performance, to corruption in the private and public sectors.

However, the last twenty years of firm and economic data indicate that three key lessons can be drawn from the transition experience of the Czech Republic, Slovakia, and Hungary. Firstly, while much attention has been granted to the types of privatization schemes implemented in each state and their relative merits and challenges, long-term outcomes suggest that the form of privatization mechanisms implemented (i.e. mass privatization through vouchers versus direct sales) has been far less relevant to economic and company performance than the ability of the states in question to establish and execute relatively rapid and comprehensive privatization efforts that allowed for a quick shift to a system of private enterprise. Data shows that privatized firms were far more likely to restructure and thus increase profitability than their state-owned counterparts. In fact, research (Pohl et.al., 1997) in the former communist bloc suggests there is little difference in the productivity performance of firms in states that deployed mass privatization programs versus direct case-by-case sales. However, profitability of firms in states that followed rapid privatization (including the Czech Republic and Hungary) was significantly higher than the profitability of firms in states that adopted a more gradual approach to privatization as Slovakia did at varying points. Successful completion of privatization therefore appears to be a precondition of (immediate or eventual) successful restructuring of enterprises.

Even if this endeavor, as in the Czech Republic, was not immediately successful, self-management of the private sector ultimately proved superior to direct government control. Moreover, the formation of a vibrant and autonomous private sector, and the transference of management capacity from the state to private actors, was critical in creating conditions for growth, eliminating wasteful or inefficient business, and alleviating political pressure from the government to support and fund failing enterprises and excessive bureaucracies. Hungary, which delayed or impeded the privatization process has been unduly burdened by inefficiencies and corruption. Slovakia, which paused its privatization program between 1994 and 1998, similarly faced negative economic performance during this period; economic growth sharply accelerated with a renewed pursuit of privatization at the end of the decade.

Second, the realization of successful private enterprise depended in large part on access to prudent yet sufficient bank lending. In this regard, private – and foreign owned – banks were more successful in both providing adequate levels of capital, and in creating transparent, judicious and stable conditions for lending. Access to finance remains a crucial element of economic growth and investor confidence. As elaborated in Chapter 7, the Czech Republic, Slovakia, and Hungary all managed to secure funding for private enterprises, although the development of their financial sectors has differed.

Finally, private enterprise hinged on appropriate but limited government oversight and intervention. According to Balfour and Crise (1993), the conversion of state enterprises to competitive free-market actors depends on a proper institutional environment that enforces and protects property rights laws, including intellectual property rights, and creates a legal system of contract laws, market entry and exit regulations related to competition and bankruptcy, and securities legislation. The strength of this legal system is in turn dependent upon political stability that creates conditions for institutional and market reform, and confidence in the continuity of policies and platforms. However, as the former communist states of Central Europe demonstrate, this argument may likewise be inverted. Countries that transferred stewardship of the economy to the private sector and positioned state institutions and mechanisms to provide support for, rather than direct administration of, the economy and the emerging private sector posted faster, more stable economic growth, and continue to enjoy healthier and more productive businesses – hence reducing economic, institutional and social volatility. Moreover, these states were better positioned to enact stable economic and fiscal policies, even in the face of unpredictable or sudden political or economic shifts. States that were furthermore responsive to specific economic challenges, and able to pass quick and effective reform measures to counteract rising issues or crises, have been the best performers over the past two decades.

The Czech Republic followed a program of rapid mass privatization chiefly to domestic owners. The Czech system suffered setbacks four years after its initiation, as a poor regulatory regime failed to contain negative forces affecting the privatization. However, the Czech scheme, which transferred control of the private sector to a range of private actors, succeeded in three critical aspects. One, the state was freed to implement policies such as budget constraints and price liberalization that supported economic development even in the face of certain social costs. Two, an unwavering commitment to private markets allowed the state to pursue policies of economic reform through periods of political turmoil, and to rapidly respond to market needs. Finally, domestic public participation in the privatization program helped implement a culture of entrepreneurship, and support for market systems. With the exception of a period between 1994 and 1998, when it eliminated mass privatization programs in favor of a failed system of direct buy outs, Slovakia’s development has followed a similar development route. As Slovakia (much like Hungary) delayed the transfer of enterprise ownership to private agents, it encouraged particular conditions that have harmed its growth prospects. Most notably, the public embraced the idea of entrenched state sponsorship of public welfare programs, incurring costs that continue to burden Slovakia’s economic progress.

Hungary was once widely regarded as a leader in privatization of state enterprises in former communist Europe, pursing a lauded system of direct sales to foreign owners. While these newly privatized firms made great gains in efficiency and productivity, the absence of widespread domestic participation in the privatization efforts had negative consequences. The state was unable to enact some politically challenging fiscal and economic policies critical to continued stability, and found it difficult to pursue an agenda of prudent fiscal management. The absence of opportunity for popular inclusion in the new market system also allowed the continued flourishing of the informal sector, which has remained staggeringly large as a share of the overall economy for the past 25 years. These factors both contributed to the depth of the financial crisis in Hungary in 2009, and have created powerful factions reluctant toward supporting a private market system.

Privatization in the Czech Republic

The Czech government actively pursued an expedient and efficient program of privatization from the very start of the transition. Under the Soviet system, Czechoslovakia had little price liberalization, little tolerance of small private enterprise, and little experimentation with workers’ councils in enterprises. The fear of a relapse to communism, and aversion to a managed economic order was perhaps stronger than in any neighboring country. Political and economic reformers believed that nothing could be expected from a slow or evolutionary approach; the government apparatus could not be harnessed to manage positive economic change. A fast and substantial transfer was needed to create new owners who would support further market reforms.

As early as 1990, Finance Minister Klaus argued against phased privatization that would restructure companies prior to opening the market to competition. He warned about the dangers of partial reforms leading to “reform traps” of corruption and rent-seeking that he believed were plaguing Poland and Hungary, and of spontaneous privatizations that permitted Communist managers to sell off assets of large state enterprises to foreign investors at low prices. Accordingly, the Czech privatization effort was significantly faster and broader than similar privatization endeavors in other Eastern European transitional states. A Czech Privatization Ministry was hastily formed in 1990, and would continue operations until its termination in 1996.

The EBRD reports that the Czech Statistical Office estimates that in 1989, only 1.2% of the Czechoslovakian labor force and 2% of all registered assets belonged to the private sector, which accounted for a mere 4% of the GDP in 1990. The Czech government adopted a specific schedule for the privatization of enterprises held in the Czech National Property Fund, a trust founded to temporarily manage state assets and assist in the technical implementation of individual privatization decisions. Private agents, not government organs, generally spurred and completed the task of rapid privatization. The government in both states was charged with playing a supporting role by pursuing price and external liberalization targets. Privatization in Czechoslovakia began in 1990 through restitutions that attempted to return or compensate property confiscated and nationalized after 1948. The first round of privatization of state assets was enacted through a “small privatization law” that targeted local shops and enterprises not contested under the Restitution Law. More than 10,000 such businesses were privatized through a system of public auctions (Balfour and Crise, 1993).

In 1991, the Czechoslovakian government expanded the privatization process to encompass an additional 6000 larger firms through a "large privatization law." Gupta, Ham and Svejnar (2008) found that more profitable firms most likely to respond to changes in demand were privatized first, while market conditions such as unemployment rates seemed to have little effect on the order of privatization. The first wave of this privatization covered 2,930 firms (2,210 of them in the Czech Republic), and began in the spring of 1992, deemed "the year of privatization" in the CSFR by Finance Minister Klaus. Firm managers were requested to submit privatization plans for their enterprises; ultimately, however, the Czech and Slovak ministries of privatization as well as the federal Ministry of Finance retained final authority over the selection of firms and approval of privatization schemes.

The Czechoslovakian Ministry of Finance implemented a unique system of vouchers in an attempt to disperse assets of large firms across a wide assortment of Czechoslovakian citizens. On October 1st, 1991, each adult Czechoslovak citizen who was a permanent resident of Czechoslovakia was entitled to purchase a voucher book with 1,000 investment "points" for Kcs 1,000 (somewhat less than one-third of the average monthly wage). Between May, 1992, and January, 1993, roughly 57% of eligible persons – some 8.56 million adults – purchased voucher books and, accordingly, bid on shares for 1,491 companies worth approximately $10 billion that had been designated for the voucher program during the first wave of privatization. Approximately 45% of shares of targeted firms were made available to citizens at highly subsidized rates through the voucher program; an additional 45% of shares were sold at market prices, while residual shares generally remained under government ownership (Gupta et.al., 2008). More than 60% of the denationalized companies were privatized through the voucher system, with the remainder sold through direct sales, auctions, and public tenders, in large part to foreign owners; 442 sales to strategic investors were conducted outside the voucher system, and only 36 of these companies were subsequently listed on the stock exchange.

However, individual shareholders quickly transferred their vouchers to the 437 newly formed investment privatization funds (IPFs) that offered to redeem vouchers at a price ten to fifty times higher than their original cost, and bid for enterprise shares on behalf of the individual investors (Hanousek and Kroch, 1998). As a result, only 28% of the points in the first privatization were invested directly by individuals, while 72% were held by IPFs, the twelve largest of which controlled some 40% of the vouchers distributed in this round. The IPFs were generally owned by banks, which acted as both creditors and owners/managers, thus creating a possible conflict of interest. Such an ownership structure undermined the health and stability of the Czech banking system, and led to collapse of the financial industry, and a subsequent economic recession in 1997. The conditions that prompted this crisis, and the concrete fiscal steps taken by the Czech government to induce growth and protect the industry from future shocks are discussed in detail in Chapter 7. The circumstances of the crisis, and the direct effect of the privatization method on its instigation undermined the credibility of the Czech voucher program, and led to wide-spread critiques of the scheme.

This unforeseen concentration of privatized assets, and subsequent concerns about anticompetitive and collusive behavior, led to the adoption of a 1997 Czech Law on Investment Funds and Investment Companies that prohibited a single fund from owning more than 20% of any company’s stock, led to better and stronger loan provisions, and improved management and elimination of weak funds. In addition, the 1997 Banking Act furthermore prohibited banks from holding controlling stakes in non-financial firms. Nonetheless, a number of both banks and funds failed between 1996 and 1997.

Yet despite such a collusion of shares, and financial difficulties experienced by some of the funds themselves, the Czech government viewed the voucher privatization process as a major success, and continued the practice for the remaining large firms (including energy, mines, the mail system, and telecommunications) in late 1993, in the second wave following the separation of Czechoslovakia. The second wave covered an additional 2100 enterprises valued at approximately $17 billion. By 1999, approximately 80% of the Czech GDP came from the private sector. In contrast, the Slovak government believed the entire voucher scheme to be slow and inefficient, and relied on more traditional privatization means (e.g., direct sales, auctions, sealed bids, and employee stock ownership plans) in its second post-independence wave.

Notwithstanding considerable urgency in the pace of reform, privatization of major industries was not effectively concluded until the following decade. Accordingly, sales of public enterprises peaked during the first and second waves in 1992 and 1994, and again in 2001. Overall, the utilities sector proved most lucrative, accounting for approximately 32% of privatization revenues, with telecommunications trailing closely at 26%. The financial real estate industry comprised 16%, and manufacturing 19% of total profits. Petroleum and natural resources rounded out the revenue structure at 4% and 3%, respectively. In the telecommunications sector, a monopoly fixed line operator remained in majority public ownership throughout the 1990s. The Telecommunications Act of 2000 established an independent regulator and determined that the fixed line monopoly would end on January 1st, 2001, although interconnection prices remained above those in the European Union well past that date. In August 2002, the government finally privatized the state's majority stake in the fixed line operator. In 1996, two Czech-owned, private mobile providers were founded. A third mobile operator entered the market in 2000 with 100% foreign ownership, and foreign private investors increased their shares to 60% in one of the Czech companies. According to WTO (2001), there has been "strong growth in both size and quality of services."

In the banking sector, the process of privatization of the four large state-controlled banks began in March 1998. The former socialist State Bank of Czechoslovakia (SBCS) "monobank" had previously been dissolved through the creation of a two-tiered banking system and four state-owned banks at the start of the transition. The actual privatization of these banks was the subject of frequent debate in the following years, but its realization was repeatedly delayed, "typically due to pressures from smaller parties in the coalition government and to very vocal leftwing opposition on this issue" (Barta and Singer, 2006). Privatization of minority or majority equity stakes in large banks via the voucher method initially failed to introduce transparent management and corporate governance, or spur appropriate government oversight. The Czech banking sector thus continued to suffer persistent structural weaknesses stemming from the Socialist central planning system, including undercapitalization, bad loans, a shortage of the long-term development funds, and poor regulations, risk management, and institutional oversight (Dědek, 2001). Finally, in 1998, foreign investors were awarded national treatment, and the supervisory powers of the Central Bank were strengthened. Recapitalization of banks by private owners increased the capital of the banking sector increased 15% that same year. In 1999, the government published a precise timetable that covered outstanding privatizations in banking. In 1995, state participation accounted for 31.5% of banks' capital, and banks with state participation held 70%

of total bank assets. In contrast, by 2001, 90% of banking assets were in foreign-controlled banks, and 27 out of 40 commercial banks were foreign owned. Subsequently, in 2002, the EU deemed the banking sector in the Czech Republic to be in compliance with the Acquis Communautaire.

On January 1st, 2001, a new Energy Act came into force providing for a gradual liberalization of the electricity and gas markets, including third party access starting in 2002. Private investors had previously gained some shares through consolidation of ownerships within the IPFs and acquisition of shares from local municipalities. Privatization of the sector progressed rapidly; the monopoly owners of gas imports and transit network, and seven out of eight regional monopoly gas distributors, were privatized by May of 2002. That very same year, the European Commission proclaimed the Czech gas and electricity sectors were prepared to enter the competitive EU energy market due to the privatization of major titans of the gas market, the restructuring of the utilities industry, and broad liberalization of electricity prices. In 2005, with final privatization of large energy and telecom enterprises, the National Privatization Fund was closed.

The Czech voucher privatization scheme suffered from some acute problems that endangered the state’s economic progress in the mid 1990s. Investment funds had neither the resources nor the capacity to effectively manage the restructuring of private enterprises. The state did not introduce an appropriate legal and regulatory framework to define relationships and rights between enterprises and investment funds; provide oversight of capital market activities; or ensure protections for minority shareholders. Finally, creditor supervision was weakened by delays in bank privatization, and poor bankruptcy legislation. Unrestructured commercial banks free of regulatory restraints, held majority ownership in several large investment funds that in turn controlled bank shares. The cross-ownership of funds and banks ultimately led to considerable tunneling of firm assets by fund managers. Thus the mass privatization mechanism, carried out in the absence of proper administrative instruments, resulted in inefficiencies and poor corporate governance. Coupled with blurred delineation between bank officials and fund managers, essentially acting as enterprise owners, these pressures resulted in an accumulation of contingent fiscal liabilities in underdeveloped banks, which spurred a significant financial crisis in 1997. By contrast, the best Czech performers were generally enterprises directly sold to strategic investors.

The banking crisis undermined positive reviews of the Czech privatization program, and of voucher schemes in general. Certainly, the poor performance of investment funds and lack of administrative regulations and oversight directly caused the 1997 financial crisis. Nevertheless, this occurrence obscures the several positive elements of the Czech voucher system that had long-term consequences for economic development. The speed of the privatization scheme undoubtedly assisted the state in escaping partial reform traps. Liberalization agendas were vigorously pursued, and hard budget constrains maintained. The transfer of economic activity to the private sector created an imperative for stable economic policies, even in the face of individual losses, and the state was largely able to withstand pressures for increased protections and subsidies of the languishing public sector. Moreover, nearly 60% of Czech adults, most of whom had never participated in a free market system, became "owners" of that system in 1993. The commitment to market reforms and private sector enterprise thus flourished in the Czech Republic in contrast to its regional counterparts. As the next chapter will demonstrate, the inclusion of the Czech public in the competitive market was critical in establishing an entrepreneurial culture capable of driving growth.

Privatization in Slovakia

The Slovak example further casts doubt on the conclusion that direct privatization that favored concentrated owners and foreign entities was preferable to the mass dispersion of shares in the voucher program. Slovak firms privatized through direct sales following the state's independence from Czechoslovakia did not outperform their counterparts routed through the voucher scheme. The first independent Slovak government, headed by Vladimir Meciar, leader of HZDS, Movement for a Democratic Slovakia, in coalition with SNS, the Slovak National Party, was predominantly comprised respectively populists and center-right nationalists with a strong rural base, and contained several elements of the former Communist regime. Unsurprisingly, perhaps, officials were determined to preserve the majority public shares in the National Property Fund (FNM) and sustain selected parts of centralized economic planning. Disapproving of the Czechoslovakian privatization engineered by Czech agents, new Slovak government abolished the voucher system. Future sales of nonstrategic small and medium enterprises were guided by new processes: the National Property Fund issued bonds that could be used to purchase stock in firms set for privatization, government-owned housing units, other goods, and the FNM itself. The bonds, made available to every citizen, were listed at a price of 10,000 SKK (around US$330), with a fixed rate of return and a five-year maturity date. A new law further expanded FNM's powers in regards to sell-offs, and the supervision and control of assignees, and introduced the institution of participation in shareholding by workers, for whom a share of not less than 10% of the capital was reserved.

However, in the absence of a strong legal and institutional tradition, sales frequently favored politically connected factions rather than strategic partners. By 1994, Slovakia had proven unable to attract foreign investment because of governmental instability and murky privatization policies. The reorientation of Slovakia's privatization framework took an institutional toll on political and economic liberalism in Slovakia. The transfer of privatization decision-making powers to the FNM eliminated horizontal checks on the privatization process. Meciar justified isolation arguing that experts could make decisions free from political interference. Although the Slovak Constitutional Court overturned this transfer of responsibilities in 2000, by then the FNM had privatized most of Slovakia's remaining industrial property at fire sale prices, through opaque means.

In May of 1993, as Slovakia considered how to continue post-independence privatization projects, Lubomir Dolgos quit as Minister of Privatization when his plans to accelerate privatization clashed with those of Prime Minister Meciar, who expressed a commitment to delay the transfer strategic companies ranging from utilities and gas companies to near defunct arms makers to the private sector. Meciar subsequently acted as Minister of Privatization and head of the National Property Fund. Consequently, in the year following Slovakia's independence, only 500 state-owned companies valued at $4.7 billion were moved to private ownership, many to Slovak officials and allies of the Mr. Meciar; 37% of Slovak firms were privatized by the end of 1994, compared to 80% in Czechoslovakia. Western companies that had expressed interest in joint manufacturing ventures had trouble finding a Slovak partner. While the rest of the region (in particular the bordering Czech Republic and Hungary) developed at a steady pace, Slovakia went through a period of economic stagnation that earned the country the name of "Europe's black hole." In the first half of the 1990s, per capita Gross National Income was less than 60% of that of the neighboring Czech Republic, and unemployment stood at 25%.

In 1998, a newly elected coalition government headed by Mikulas Dzurinda of the SDK (Slovak Democratic Coalition, later SDKU, Slovak Democratic and Christian Union), implemented a radical plan of economic reforms, including a shift in the Slovak privatization program. The “gradualist” approach of privatization was abandoned in favor of an energetic liberalization policy, set to complete privatization of key sectors by 2002, and opening of the market to foreign investors along the lines of the Czech model. Major industries were pushed towards the private sector, with the largest privatization operations taking place in the energy sector: 49 percent of the capital of the Slovak Gas Industry (SPP) was transferred to a consortium formed by Gaz de France (France), Ruhrgas (Germany) and Gazprom (Russia) in 2002. The national principal oil company that was privatized through a series of controversial operations between 1995 and 1998 finally transferred majority ownership to independent, foreign owned entities, and the three regional power companies sold majority shares to private, foreign owners. In 2004, the last major energy company was sold to a foreign investor, thus completing the privatization of the sector. Banks and telecommunications firms were likewise sold off to foreign owners in this period.

Contrary to stated Slovak warnings in 1993, the Czech Republic’s broadly distributive privatization program did not threaten democratic institutions. On the contrary, Slovakia’s narrowly distributive program was enabled only through a significant erosion of a transparent, public process. While rent seeking and corruption accompanied both programs, the close association of rent seekers with the ruling coalition in Slovakia led to greater governmental inflexibility in dealing with economic crisis. Additional reforms seeking to eliminate rent seeking took place only after prolonged economic crisis contributed to a sound defeat for the incumbent government in a high stakes electoral contest that pushed democratic institutions to their limits. Czech governments, by contrast, have been faced with a more diffuse pattern of post-privatization rent seeking and have thus been able to move forward with reforms without high stakes electoral conflict. First, privatization in the Czech Republic reduced distributional conflict by initially attempting to reward almost everyone. Industrial managers gained some insider advantages, but foreigners, new financial actors and most importantly, average citizens were also allowed to play an important role. Hence, by succeeding in stemming the efforts of industrial insiders to gain control over the design and implementation of the privatization process, the Klaus regime ensured that there was no single influential interest group whose basic material interests were fundamentally threatened by the operation of liberal political institutions. The result has been a smoother, less hazardous progress towards democratic consolidation.

The ability of the Czech Republic to adopt further economic measures, ranging from support for new enterprises, to hard budget constraints including a limit on public spending and strict inflation targets, drew on this popular support for the establishment and advancement of a free market system dominated by private firms and actors. Over 80% of the Czech population had, at some point, participated in the voucher scheme. The ability of the Czech Republic to quickly respond to the 1997 crisis and engineer an economic turn-around while resisting calls for greater government support of public welfare programs and protection of state-owned enterprises would not have been possible under conditions of slow or fragmented privatization. In the years since its independence, the Czech Republic has been subject to frequent political instability: despite the dominance of a few political parties, governments have rarely stayed in power for a full term; voter participation and public confidence in the government has historically been low;

and inefficient public administration remains a major obstacle toward further economic progress. Nonetheless, the private sector economy has thrives as each successive government has reaffirmed a commitment to a competitive, free, European-focused market.

Since shifting its focus back toward a free market, private economy, Slovakia, too, has achieved impressive economic gains. The initial public participation in the voucher system created a similar civic investment into the new system, although the effects were significantly tempered due to Slovakia's pull-back from the program in the mid-1990s. Slovakia thus illustrates both the advantages of rapid, mass privatization, and the long-term detriments of delaying the privatization process and confining it to a select group of investors. Public confidence in the new economic markets allowed Slovakia to carry out substantial reforms necessary to qualify for the Eurozone. Still, as privatization slowed in Slovakia in 1994, the government maintained an excessively high level of state-sponsored protections that it has since found difficult to shed. An inflexible labor market, and an extreme program of public welfare have proved to be the greatest drag on economic growth over the last twenty years.

Privatization in Hungary

In Hungary, the hastily reforming Communist Party leadership, which enjoyed unprecedented autonomy from the Soviet center, paved the way for democratization through a series of historic compromises with the politically active and visible civil opposition. By the end of the 1980s, the regime had effectively ceased central management of the economy in favor of an increasing private sector with accompanying reforms and some liberalization in trade, banking, taxation schemes, and corporate governance. At the time of Hungarian independence, the private sector already represented over 30% of GDP, as compared to an average 20% of the GDP for transition countries as a whole (Estrin, 1994). The coalition ruling elite in Hungary that emerged following independence, and included many elements of the former regime, did not view communism as a particular evil or threat. Privatization was thus considered secondary to liberalization and economic reform. Hungary's first ruling party, the Hungarian Democratic Forum (MDF), led by Jozsef Antall, introduced ambitious and wide-reaching measures designed to orient Hungary toward an export-based economy.

However, Hungary faced two distinct challenges that guided its privatization considerations. The last phases of communist rule had transferred management of quasi-independent, if state owned enterprises away from central command to self-governing managerial groups. The government believed these organizations had stripped assets of enterprises, and rejected the suggestion of any insider or mass privatization schemes that nominally shifted ownership to citizens but preserving management and oversight power within these groups. Furthermore, Hungary met independence with the highest level of per capita debt in the region, and required an immediate influx of capital from privatization. Persistently high levels of public spending, a devalued currency, and removal of subsidies on basic consumer goods drove the economy to a sharp crisis by 1994. Capitalizing on the nostalgia for the security of the former communist regime, the Hungarian Socialist Party won an overwhelming majority in the parliamentary elections. Yet a year into its mandate, unable to halt the fall of the Hungarian economy, the government introduced a Bokros package of austerity reforms that was marked by two main principles: a reduction in social spending, and intensified privatization. Still, Hungarian spending levels remained well above those of the Czech Republic or Slovakia. Hungary never instituted hard budget constrains, and increases in spending and deficit needed to be offset through immediate privatization gains.

Until 2001, privatization policy was hence guided by the intense need of the central government to generate quick revenue in order to relieve the state budget deficit. State ownership was drastically reduced in such “cash cow” companies as the Hungarian oil company (MOL) and the National Savings Bank (OTP) (Voszka, 2003). These economic considerations led Hungary to orient its privatization program toward sales to strategic investors, and to fully welcome the participation of foreign investors. Hungary’s unique conditions and historical alliances at the breakup of the communist bloc permitted the achievement of this bold step that no other government (except Estonia) felt able to take at that time. The Privatization Act of 1995 represented an essential step in establishing the legal background for the changes in the proprietary structure of the country. The law increased the range of assets that were permitted to be privatized by withdrawing the boundaries of permanent state property. The rapid privatization program that followed transferred almost 90% of state assets to private ownership by 1998, including in key industries such as banking, telecommunications, and energy. Yet the socialist government, mindful of the spectacular electoral defeat of its predecessor, sought to strengthen social safety nets through newly privatized firms. The government implemented provisions that required a firm’s labor force to be held largely intact, and enterprises that shed more than 10% of the workforce in the three years following privatization faced substantial financial sanctions. Still, the influx of foreign ownership, and Hungary’s emphasis on corporate governance did lead to better restructuring of Hungarian firms. The World Bank judged Hungarian corporate governance performance to be the best in the region.

Almost all of 1,859 former socialist enterprises designated for privatization in 1990 as to-had become completely privately owned or liquidated by the end of the 1990s. The policy approach during the large-scale privatization period was further strengthened under strong pressure from the European Commission to balance the national budget before accession to the EU (Iwasaki and Suganuma, 2009), leading to the steady privatization of dozens of government-owned companies left in the portfolio of the Hungarian Privatization and State Holding Company (ÁPV Rt.) and other public firms, mainly through open bidding. As tensions in the state budget decreased in the late 1990s and early 2000s, state asset management considerations changed: the privatization process slowed down, and long-term asset management priorities emerged (Voszka, 2003). The share of SOEs in the total number of employees and total added-value for 2002 (2005) shrank to 15.0% (12.0%) and 17.6% (15.6%), respectively.

By the mid 1990s, the Hungarian government had made substantial progress in selling banks to reputable foreign strategic investors, adopting strict banking regulation and bankruptcy laws, and eliminating large stocks of bad loans in the banking system, a process that did not gain momentum in the Czech Republic and Slovakia until the end of the decade. The banking sector had been open to foreign activity since before the end of communist rule; three external banks had operated in the state since 1985. By the end of 1996, three of the four large state-owned banks in Hungary were under foreign ownership. The introduction of foreign capital and expertise into Hungarian firms and banks solidified prudent competitive and lending practices, so propelling growth in the second half of the 1990s. Nevertheless, the presence of foreign capital and influence in the Hungarian banking system left the country particularly vulnerable to external financial shocks, as was evidenced by the deep recession that enveloped Hungary in 2009. More than 50%

of manufacturing firms were under foreign ownership by 1995, and foreign investors accounted for 62% of all investments by 1996.

Furthermore, the privatization process in Hungary, which favored sales to single, highest bidders, excluded a large segment of the Hungarian population from the new market. Private business activity had been better tolerated in Hungary under the communist regime than in its Iron Curtain counterparts, and indeed, comprised a substantial portion of all economic profits under communist rule. Yet these private firms and operations existed largely outside the formal state structure. Hungary thus entered into a market economy regime with a cultural and entrepreneurial legacy of operating through informal channels and mechanisms. It is possible that a mass privatization scheme would have encouraged higher public participation in the formal market system; certainly, the focus on the sale of large SOEs to private, foreign investors allowed many agents to remain within the shadow economy. The informal sector in Hungary in 1992 accounted for almost a third of all economic activity; today, it continues to represent approximately a fifth of the total economy. With so much market activity occurring outside government oversight and tax obligations, and with such a low participation of the general public in the formal market system, the conundrum of Hungarian economic accomplishment from 1995 to 2008 and subsequent struggle can be framed not as question of what has crippled the economy in the last seven year, but how such a successful economy could be built. While foreign investment, driven in great part by privatization, could underwrite domestic spending, Hungary prospered. Its own economic abilities, unfortunately, have proved to be underdeveloped.

Summary

While the Czech Republic, Slovakia, and Hungary all reached ownership transformation of its business sector by the close of the decade, the speed and method under which they proceeded sharply differed. Although Hungary's privatization program was slowest within the CEE, early economists nonetheless quickly commended the state for optimizing firm performance, restructuring and efficacy – the traditional measures of privatization success – through direct sales to foreign owners. However, more than two decades from the start of privatization efforts in the CEE, it has become evident that lingering effects of varying schemes include several further considerations. The relative success of the implementation of privatization programs can also deliberate through its ability to harness public support and participation in the private sector, and the creation of a native, domestic sector insulated from external shocks. On these measures, the Hungarian program has fallen short of its Czech, and – to a lesser extent – Slovak counterpart. The broader, faster, and more inclusionary processes in the latter two states enabled economic conditions that spurred the emergence of a competitive free market environment, and supported private sector development. These two developments will be discussed further in the coming chapter.

CHAPTER 7: PUBLIC SUPPORT FOR ENTREPRENEURSHIP

As free market economies took root across the Central Europe over the past two and a half decades, the region encountered a condition commonly found even in mature capitalist systems: private sector development, driven by consumer and investor preferences as well as domestic and foreign trends, frequently outpaces the development of state policy. The ability of states to affect economic progress is therefore principally channeled through investment into a vibrant entrepreneurial sector with the capacity to generate growth. The benefits of entrepreneurship have been empirically identified as driving innovation; job creation; productivity and growth; and utility of individuals through heightened income and life satisfaction. These, in turn, create spillover effects into other industries and regions – indeed, the building blocks of economic advancement (Van Praag and Versloot, 2007). States play critical, if supporting, roles in driving the entrepreneurial process through the institution and perpetuation of a stable and predictable market environment. Governments that are able to institute prompt and flexible responses to private sector challenges are better able to support the growth of entrepreneurship. Conversely, states that attempt to preserve former systems and industries, or directly control the course of economic development, can ultimately obstruct growth.

The 1990s marked the ascendance of entrepreneurship to the forefront of the economic policy agenda, chiefly as a response to the low economic growth and high unemployment rates in Europe during the period. The concept of entrepreneurship policy, and the importance of investment in human capital in a globalized economic context, was particularly stressed after the perceived failure of the development schemes of the capital-driven Solow economy and the

Romer model. Since this shift, entrepreneurship has been recognized as a vital component of employment and economic growth, and policies designed to spur entrepreneurship as an engine of economic growth and employment are a hallmark of a broad spectrum of national economic programs. (Audretsch, et al. 2007).

This chapter will reflect on the evolution in the policies of economic development in Central Europe. It will examine state support for the entrepreneurship in the Czech Republic, Slovakia, and Hungary through the formation of an environment conducive to private firms. The latter can be achieved through institutional stability; presence of sound financial sector marked by prudent bank lending, and access to capital; and encouragement of SMEs. Although literature does highlight the importance of investment into relevant industries and human capital in promoting entrepreneurship, research and development, infrastructure and human capital indicators are very similar across the three states, and will thus not be considered in particular detail. Finally, this thesis will propose that rapid and inclusive liberalization and privatization efforts were more favorable to opening space for the private sector. The respective success of economies in of Central European in the last quarter century has been undoubtedly shaped by the development trajectories and priorities established in the early stages of the transition period through liberalization and privatization. As this thesis has established, Czechoslovakia began the transition with broad consensus among economic and political leaders regarding the importance of privatization and market structures. Subsequently, the Czech Republic, and to a somewhat lesser extent, Slovakia, successfully completed the rapid transfer of economic management to the private sector, and generated widespread public support for, and participation in the new economy – though these processes were not without difficulty. Hungary, by contrast, did not set or accomplish clearly defined domestic economic targets, nor engage citizens in the entrepreneurial practice through inclusive privatization schemes.

Review of entrepreneurship literature

The literature on the role of entrepreneurship in driving economic development has principally focused on two general areas: the contributions of entrepreneurship, or, more specifically, of an entrepreneurial culture to productivity, employment and economic growth; and the impact of government policies on entrepreneurial (and, in turn, economic) advancement. Certainly, the two spheres of study are inextricably linked; indeed, some research suggests that entrepreneurship is only beneficial to the overall economy under a stable, mature institutional and political background (Henrekson, 2007). Yet, despite the global emphasis on the importance of entrepreneurship, data on whether and how entrepreneurship factors into economic growth is not forthright. Moreover, there has been comparatively little empirical analysis of the part played by the policy environment (Georgellis and Wall, 2006), and the ability of public strategies and agendas to spur private sector activity is poorly understood (Naudé, 2010). Most evidence in support of policies that encourage entrepreneurial activity remains anecdotal.

The impact of entrepreneurship on economic development has yielded a broad literature, although it has largely been contained to two elements: the establishment of individual firms, and regional studies. Studies that have linked entrepreneurial activity to economic growth at the national level have been relatively scarce (Carree and Thurik, 2003). Empirical literature on standard economic growth has set forth a variety of economic indicators (Sala-i-Martin, 1997), but generally has not included entrepreneurship. However, the measurement of the factor of ‘entrepreneurship’ is an undoubtedly complex undertaking. No formal definition of entrepreneurial activity exists; aside from self-employment and self-reporting measures of questionable reliability, there are no true cross-country measures of entrepreneurship; and government support for entrepreneurship has been difficult to isolate from other variables (Ahmad and Seymour, 2008).

Studies that have attempted to study entrepreneurship have roughly divided into three main streams of research. The first, rooted in a sociological and psychological approach, has tried to explain the ‘causes’ of entrepreneurial behavior through examinations of entrepreneurial traits (see e.g. McCelland, 1965; Rotter, 1966; Brockhaus, 1982). The second, in the field of management, has largely focused on best practices and the development of strategies for advancement of entrepreneurial firms (Stevenson and Jarillo, 1990). Finally, advancing classical contributions like those from Schumpeter (1934), and Kirzner (1973), economists have attempted to assess the economic effects of entrepreneurship. More recent studies have begun to bridge these different approaches. In a seminal work, Freeman (1976) built on McCelland pivotal 1961 study to reveal the significant impact of entrepreneurial culture on determining diversity of national products. Morris, et al. (1994) discover corporate entrepreneurship declines with an emphasis on collective identity, implying that government and cultural practices do indeed have a assessable impact on entrepreneurial activity. Still, notwithstanding these contributions, many of the studies that purport to show associations between entrepreneurial values and economic performance do so only incidentally. Entrepreneurial culture is generally analyzed only as a regional and fixed variable (Wagner and Sternberg, 2002), or contained within an exogenous indicator (Lucas, 1978).

In contrast, a hypothesis that attributes a central role to entrepreneurial discovery, argues that traditional neoclassical microeconomics do not provide a fitting model for understanding developments in market economies (Kirzner, 1997; Yeager, 1997). Theorists in this school posit that the market is shaped and directed by entrepreneurs who fulfill a ‘cost-discovery’ function and provide financial externalities by exploring the viability or new products, markets, and activities (Hausmann and Rodrik, 2003). Entrepreneurs further power growth through their capacity to innovate and to win new global markets for technologically advanced products (McArthur and Sachs, 2002). Entrepreneurial innovation may also shift the technology frontier, enhance knowledge of what is technically viable, and test and reveal consumer preferences through the introduction of new goods and services. Entrepreneurs are central in this progression due to their inclination to assume risk in new markets and products, which allows them to influence – and, in some cases, set – price and output data (Kirzner, 1997). Yet this propensity for risk, which propels economic growth is, according to this school of thought, rather scarce. Thus, two points emerge: a preponderance of entrepreneurial agents in a particular state results in increased economic dynamism and growth. Furthermore, countries and regions that are characterized by a culture or government programs that are conducive to entrepreneurship may be more innovative, and so more likely to develop.

Several authors look at the role of entrepreneurship in the guiding the structural transformation of underdeveloped economies toward a modern system that optimizes production, consumption and labor market matching. Some studies that examine the specific ways entrepreneurs impact growth are summarized below.

Rada	**2007**	**Entrepreneurs trigger an inflow of investments by identifying opportunities for profit and innovation, and reallocating inputs of production toward those industries.**
Peretto	1999	A revised endogenous growth model that hinges long-term structural adjustments on the ability to move an economy from a Solow path of capital accumulation, to an innovation path of knowledge accrual, best accomplished through entrepreneurship.
Murphy et.al.	1991	Firm size and economic growth are a function of entrepreneurial aptitude
Nelson and Pack	1999	Entrepreneurial efficiency and ability defines the market's capacity to assimilate technology and an expansion in skilled human capital. In the absence of such entrepreneurial aptitude, returns to human and physical capital are low.
Michelacci	2003	Entrepreneurial ability is likewise critical for expansion and effectiveness of R&D investment.
Gries-Naudé	2010	High skill entrepreneurs generate and implement more innovative and complex production methods, and create more specific and complex intermediate inputs, so advancing a state's technological strength.

Stel (2005) determines that European Union member states that quickly moved industries and sectors (especially manufacturing) toward diffusion, competition, and decentralization through a growing proportion of SMEs, have realized faster economic growth. Therefore, it can be deduced that states in Central Europe that undertook faster and more radical liberalization and privatization programs that introduced competition, removed support for inefficient state industries, encouraged the emergence of SMEs, and broke up large centrally-owned conglomerates could move toward faster growth. Stel also finds that while total entrepreneurial activity positively affects economic growth across a wide range of mid and high income states, the effect increases with per capita income. Curiously, an increase in entrepreneurship has a negative impact on growth in low-income states. Stel hypothesizes that this phenomenon can be attributed to differences in levels of human capital, which are higher – and hence better able to exploit benefits of entrepreneurship – in more developed countries. Similarly, he emphasizes the importance of the sector of economic activity, as the impact of entrepreneurship on growth is stronger in the manufacturing rather than service sector, and the quality and quantity of entrepreneurial supply. However, all states considered in this thesis lie above the threshold of income required for entrepreneurship to positively influence growth. Moreover, their initial income levels in 1990s, and the sectoral structure of their economies are comparable enough to enjoy similar levels of entrepreneurial impact.

Yet while data allows the possibility (or even probability) of policy inferences, on a research level, few specific strategies promoting entrepreneurial growth have been considered for their impact on economic development. Empirical studies that attempt to link policies to entrepreneurship are in their infancy, and an established methodology has not yet emerged (Ahmad and Seymour, 2008). The difficulty in attempting to quantify the impact of policy on entrepreneurship is evident in Storey and Tether's (1998) seminal study that examined five government measures designed to encourage high technology SMEs (defined as New Technology-Based Firms, or NTBFs), within the European Union during the 1980s. In later studies, Storey (2003) and Storey and Potter (2007) underlined and stressed the difficulty of evaluating such programs due to the opaque nature of targets, and the difficulty of translating policy agendas into quantifiable, unified variables. Consequently, authors were unable to determine the statistical significance of the individual government plans, and instead recommended that policies should be in line with macroeconomic objectives (Storey and Potter, 2007). Nevertheless, a series of more recent breakthroughs has accelerated the expansion of the knowledge base on entrepreneurship. Lundstrom and Stevenson (2005) attribute this shift to an improvement in SME statistical data; a heightened ability to measure levels of entrepreneurship and the behavior of "nascent entrepreneurs" across countries; access to best practices studies on entrepreneurship policies and programs; and an increase in knowledge sharing venues. Specifically, the Global Entrepreneurship Monitor, published annually since 1999, has introduced unified measurement standards of entrepreneurial behaviors and attitudes, and national contexts that impact entrepreneurship (Reynolds et.al., 2005).

On a theoretical level, this change has led to the construction of a framework that stresses the multi-dimensionality of entrepreneurship policy that embraces a broad spectrum of institutions, agencies and different constituency groups (Audretsch et.al., 2007). Government schemes thus cannot consider merely how to deploy specific instruments geared toward a particular sector or industry, but must instead reflect on the overall role of public policy and institutions in creating an environment conducive to entrepreneurship the economy (Audretsch et.al. 2007). Phelps (2003) argues that the degree of dynamism in a state's economy hinges on its development of some key economic institutions, including company law and corporate governance; the preparation of the population for private sector participation; and the establishment of financial agencies and resources, such as the stock exchange. When applied to entrepreneurship policies, Hart (2002) posits that public policy and governance can shape virtually all of the contextual determinants of the demand for entrepreneurship and, over a longer time scale, the supply of entrepreneurs. Furthermore, Hart (2002) concludes that, "knowledge and power linkages between policy process and policy content are likely to be particularly strong in the making of entrepreneurship policy" (pg. 289). He suggests that granting entrepreneurs an active role in transferring required knowledge, and strong political power to influence policies is critical in determining levels of entrepreneurial activity. Within that context, Douhan and Henrekson (2007), and Henrekson (2007) propose that institutions must take a central responsibility for founding a business-friendly environment, and so ensuring the success of government policies.

There are several policy lessons that can be drawn from the data on entrepreneurship and economic growth despite the lack of empirical evidence on the success of such individual programs. Firstly, as the newer theoretical models propose, institutional and legislative frameworks are critical in promoting the development and wealth of entrepreneurial activity. Low barriers to entry and exit of businesses, regulatory standards that establish conditions for business development, and institutional stability that encourages consumer confidence are important for sound economic development. Harper (2003) suggests that the three factors fundamental for the advancement of entrepreneurship are the rule of law, the certainty of the law, and the equality and generality of law, particularly as they apply to private property protections and contracts.

In addition to institutional efficiency, better financial systems similarly improve the likelihood of successful innovation, and hence promote economic growth. On the contrary, financial sector distortions depress economic growth by diminishing the rate of innovation (King and Levine, 1993). Availability of credit and finance has been a hallmark of global development literature in the last two decades: empirical studies generally find a weak but positive correlation between economic development and financial access both at the individual and firm level (Beck, Demirgüç-Kunt, and Martinez Peria, 2007), and presence of capital is undoubtedly essential to both health of private households and enlargement of enterprise. Research has emphasized the benefits of inclusionary financial access over capital redistribution policies that may create disincentives for work and savings (Demirgüç-Kunt and Levine, 2007). In practical terms, these findings can translated into specific policy recommendations: states should promote financial sector reforms that stabilize and strengthen the financial industry, reduce financial market imperfections, and encourage inclusion and prudent lending to expand business and individual growth opportunities.

Secondly, governments should engage in steps to encourage small and medium enterprises due to their ability to grow economies. David Birch (1979, 1987) was among early scholars who empirically proved that the majority of jobs in the United States are created through fast growing small businesses (Birch 1979, Birch 1989). Birch's (1979) data and analysis showed that 82% of the new net jobs generated in the United States between 1969 and 1976 arose from the small firms sector (Birch 1979). More recent research (Carland and Carland, 2004) confirms that the greatest impact on the US economy during the 1990s, and the greatest potential for future economic development, lies within firms with fewer than 20 employees. Government policies designed to support entrepreneurship must therefore foster the development and prominence of the SME sector.

Yet the question of how to prompt and nurture the creation and advancement of SMEs has not been precisely empirically determined. Existing research does, however, offer some insights into schemes that might be particularly favorable or detrimental to the development of SMEs, and firms in general. Lower tax margins and simplified regulatory regimes do encourage the formation of new enterprises (Storey, 2008). More direct approaches do not necessarily yield positive outcomes: A study conducted on the impact of new firm foundation in Britain during this period found no evidence that Britain's "birth rate" state policies, intended to increase the number of new firms, led to higher rates of employment (Stel, 2005). Indeed, the study concludes that subsidizing entry costs rather than lowering administrative burdens related to starting a new business generates artificial conditions for firm growth, and generally does not enhance economic development. Stel (2005) thus warns against subsidizing the entry of new firms onto the market, as they may be unable to survive in a competitive environment. Business policies that involve creating a financial advantage for some firm owners may attract individuals who are not intrinsically motivated to start a new firm, or concentrate firms within unviable sectors, absorbing physical and human capital and time that could have been more productively allocated in another enterprise (Carree et.al., 2002).

Instead, a review of the literature on new firms suggests that government schemes should indirectly support (rather than manage) entrepreneurial activity through investment in human capital, the construction of a business culture that supports and encourages entrepreneurship, and assistance in key sectors necessary for the establishment of entrepreneurial centers, such as infrastructure and R&D. In that vein, Georgellis and Wall (2000) examine levels of British entrepreneurship, as defined by rates of self-employment, between 1983-1995, and show that – in addition to standard economic measures including labor market and industry characteristics and conditions – "entrepreneurial human capital" is a key and diverging explanatory variable in determining relative success of specific regions. In existing firms, this factor may contribute to growth, strategic revival, and increased competitiveness and innovation (Leibenstein, 1968; Wennekers and Thurik, 1999).

The importance of human capital is further illuminated through a regional analysis of the effects of regional particularities on private start-ups in Finland. Kangasharju (in Beugelsdijk, 2007) identifies several significant regional traits that influence the rates of new firm formation: regional growth; accumulation and rates of urbanization; government policies; and “entrepreneurial ability” that is determined by the stochastic distribution of entrepreneurial talent within the population, and by regional specificities that include both human and physical capital. Similarly, an empirical study of new firm formation in Sweden shows that regional growth of new enterprises was associated with the presence of entrepreneurial values (Davidsson, 1995, in Beugelsdijk, 2007). A cross section examination of 54 European regions found that regions differ in terms of entrepreneurial attitude, and that a propensity toward entrepreneurship, as measured by a high rank on the entrepreneurial characteristics index, is linked with a faster rates of regional economic growth (Beugelsdijk and Noorderhaven, 2002).

Research on the appropriate avenues of government investment has produced less cohesive findings. Ciccone and Matsuyama (1996) argue that direct assistance may be warranted in particular instances, as economies that produce a limited range of intermediate goods use ‘primitive’ production methods of final, consumer goods, and have little demand for sophisticated novel inputs. This in turn leads to lower incentives for potential entrepreneurs to establish new firms, and trapping the economy in a cycle of underdevelopment. Bolstering the production of new intermediate goods may in such cases lead to shifts in demand patterns and greater interest in entrepreneurship. The authors argue governments may thereby need to provide assistance to new firms in the form of pecuniary and technological resources to offset firm R&D costs of bringing new goods to the market. However, Acemoglu et al. (2013) underscore that this assistance should be directed toward new firms; industrial policy subsidizing either the R&D or the continued operation of incumbent firms deters entry of new competitors and so reduces economic growth and welfare. Conversely, subsidies for R&D by incumbents and new entrants that are accompanied by taxes on existing firms offer substantial improvements in welfare and growth, since inefficient firms are removed from the market, and resources are redirected toward the survival and expansion of profitable and productive incumbents and entrants. Acemoglu et al. (2013) argue that government policies should thereby link the reallocation of resources to innovation and include an exit margin for less productive firms.

Entrepreneurial development

In considering the promulgation of entrepreneurship in Central Europe, this section will provide a snapshot of the relevant data, and examine the principal drivers of entrepreneurial activity as identified by empirical literature: the establishment of a business environment characterized by institutional stability, an effective regulation regime, and an absence of corruption; access to monetary support and credit from the financial sector, which in turn must engage in prudent lending and adequate capital; expansion of the number and vitality of SMEs; and investment in research and development, and infrastructure, rather than direct subsidization of industries or firms. It will moreover link some of the practices, decisions, and trends in the Czech Republic, Slovakia, and Hungary to legacies of liberalization and privatization processes.

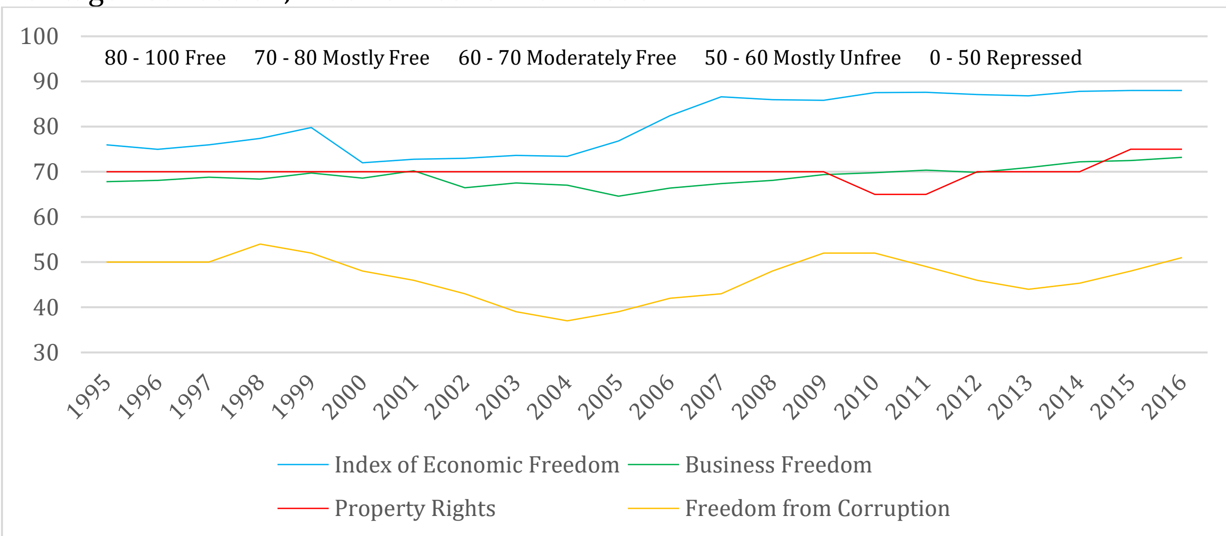
Radical liberalization and privatization programs in the Czech Republic quickly opened up space for private enterprise. The continuing commitment of successive Czech governments to pursue policies of greater liberalization, privatization, and integration into the European and global economic system through the establishment of a strong private market has resulted in a vibrant, well financed private sector. Undoubtedly, problems persist; some the legacy of the communist regime, some created by policies implemented since Czech independence. The greatest challenge to the business environment remains slow and burdensome public administration that leads to difficulties ranging from obstructions in founding a business to corruption. As in much of Central and Eastern Europe, investment in infrastructure and R&D remains low. However, as the private sector in the Czech Republic has been largely self-regulated, it has managed to thrive despite these impediments. Productivity and production have posted strong growth during much of the past two decades, and Czech companies have been competitive both domestically and abroad. Indeed, good insolvency mechanisms and relatively few subsidies have meant that underperforming firms have largely exited the market, opening space and resources for dynamic companies. Moreover, the transfer of business stewardship to private agents has led governments to incentivize private sector growth through investments in key sectors, including SMEs, and tax regimes designed to attract investment, and has made it easier for governments to push through socially controversial measures including employment cuts and pension reforms.

In Slovakia, much of the economy was transferred to the private sector quickly, in part due to the broad voucher privatization scheme carried out in Czechoslovakia, and the state was celebrated as one of Central Europe's top reformers (Sachs, 1995). Nevertheless, the abandonment of the voucher system for large enterprises in favor of opaque sales to insiders that failed to attract new financial resources and external expertise, and protectionist policies targeting key sectors that locked resources in underperforming firms, undermined the development of entrepreneurship and firm restructuring in mid 1990s. Yet the deep shift in Slovak economic policy brought on by a new government in 1998 effectively revitalized plans to transfer management of the economy to the private sector. Subsidies were rejected in favor of investment in key industries, access financing and credit, business oriented tax regimes, and proper exit mechanisms critical to maintaining firm competitiveness. The advantages provided to the business, and particularly industrial sector, and the challenges including corruption, posed by an inefficient public administration, have thus mirrored those in the Czech Republic, although Slovakia's delayed move to a competitive free market has led to a continued lag behind its neighbor. Assurances of employment protections in the early 1990s, moreover, created an expectation of extensive social safety nets; Slovakia has thus struggled to shed social protections that form a massive burden on the state.

The initial success of the Hungarian economy in the first decade following the transition appeared to be a resounding endorsement of its direct privatization schemes, and aggressive expansion towards foreign markets and investors. However, Hungary's actual development path in the 1990s was at time at odds with its image as an emerging Central European economic power, and certain indicators, including the prevalence of a shadow economy, and dearth of SMEs, highlight weaknesses of the Hungarian business environment that became evident in the aftermath of the financial crisis. The liberalization of the Hungarian economy in the 1960s, and the positive assessments of Hungary's privatization and democratization in the 1990s belied the reality that liberalization efforts were led by elites, and not by the general population. Moreover, liberalization efforts did not, as in the Czech Republic, transfer full responsibility for the economy to the private sector. Subsidies remained a key element of the national economic strategy, allowing uncompetitive firms to remain in the market. While external investment and government spending could together combine to generate economic growth, Hungary's status as a free-market participant was not questioned. Yet both foreign and government investment collapsed in 2008, depressing a state budget already overburdened by large deficits on its current and fiscal accounts, and putting further strain on a private sector flush with debts held in foreign currencies. Hungarian companies thus found themselves without artificial means of support, and the Hungarian entrepreneurship sector has continued to struggle.

Figure 7.1: Czech Republic

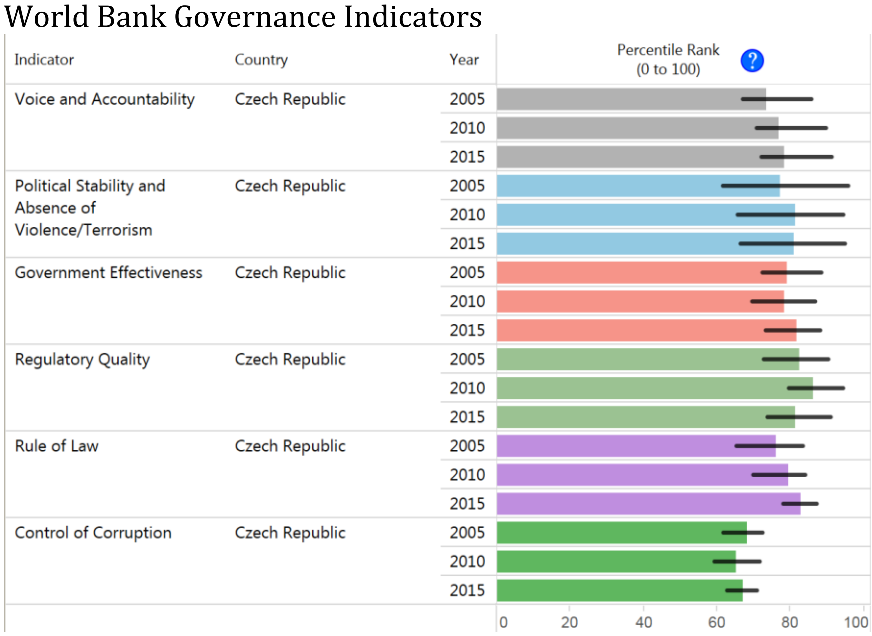
Heritage Foundation, Index of Economic Freedom



Transparency International Perception of Corruption Index

	1998	2015
Global Rank	37	37

World Bank Governance Indicators



World Bank Ease of Doing Business, select indicators

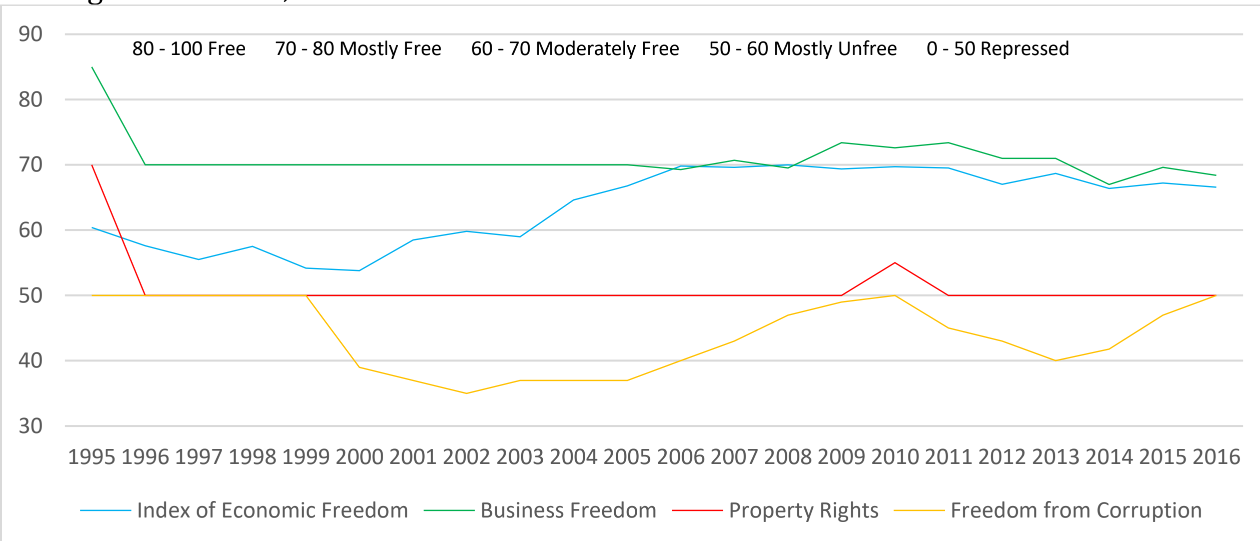
Year	Rank	Overall DTF	Starting a business-Rank	Starting a business-DTF	Starting a Business - Time (days)	Starting a Business - Cost (% of income per capita)	Dealing with Construction Permits-Rank	Getting Electricity-Rank	Registering Property -Rank	Getting Credit-Rank	Getting Credit - Strength of legal rights index (0-12)	Getting Credit - Depth of credit information index (0-8)	Getting Credit - Credit bureau coverage (% of adults)
2017	27	76.71	81	86.86	9.0	5.7	130	13	31	32	7.0	7.0	79.2
2016	26	76.43	88	85.23	15.0	6.7	126	13	31	29	7.0	7.0	78.7
2015		75.89		85.08	15.5	6.9					7.0	7.0	76.6
2014		71.66		83.22	15.5	7.0					5.0	7.0	76.0

Year	Protecting Minority Investors - Ease of shareholder suits index (0-10)	Protecting Minority Investors - Extent of shareholder governance index (0-10)	Protecting Minority Investors - Extent of shareholder rights index (0-10)	Protecting Minority Investors - Extent of corporate transparency index (0-10)	Paying Taxes-Rank	Paying Taxes - Payments (number per year)	Paying Taxes - Total tax rate (% of profit)	Paying Taxes - Profit tax (% of profit)	Paying Taxes - Labor tax and contributions (% of profit)
2017	9.0	6.7	8.0	5.0	53	8.0	50.0	9.1	38.4
2016	9.0	6.7	8.0	5.0	53	8.0	50.4	9.5	38.4
2015	9.0	6.7	8.0	5.0		8.0	50.4	9.5	38.4
2014	9.0	6.7	8.0	5.0		8.0	50.0	7.5	38.4

Year	Enforcing Contracts-Rank	Enforcing Contracts - Time (days)	Enforcing Contracts - Cost (% of claim)	Enforcing Contracts - Quality of judicial processes index (0-18)	Resolving Insolvency-Rank	Resolving Insolvency - Recovery rate (cents on the dollar)	Resolving Insolvency - Time (years)	Resolving Insolvency - Cost (% of estate)	Resolving Insolvency - Strength of insolvency framework index (0-16)
2017	68	611.0	33.0	10.5	26	66.5	2.1	17.0	13.0
2016	67	611.0	33.0	10.5	22	66.0	2.1	17.0	13.0
2015		611.0	33.0			65.6	2.1	17.0	13.0
2014		611.0	33.0			65.0		17.0	13.0

Figure 7.2: Slovakia

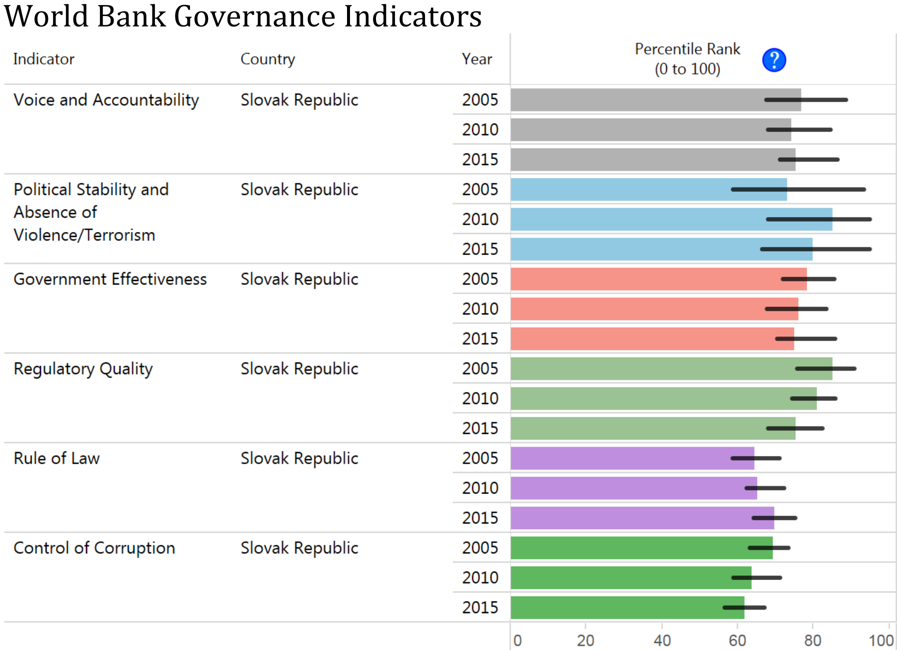
Heritage Foundation, Index of Economic Freedom



Transparency International Perception of Corruption Index

	1998	2015
Global Rank	47	50

World Bank Governance Indicators



World Bank Ease of Doing Business

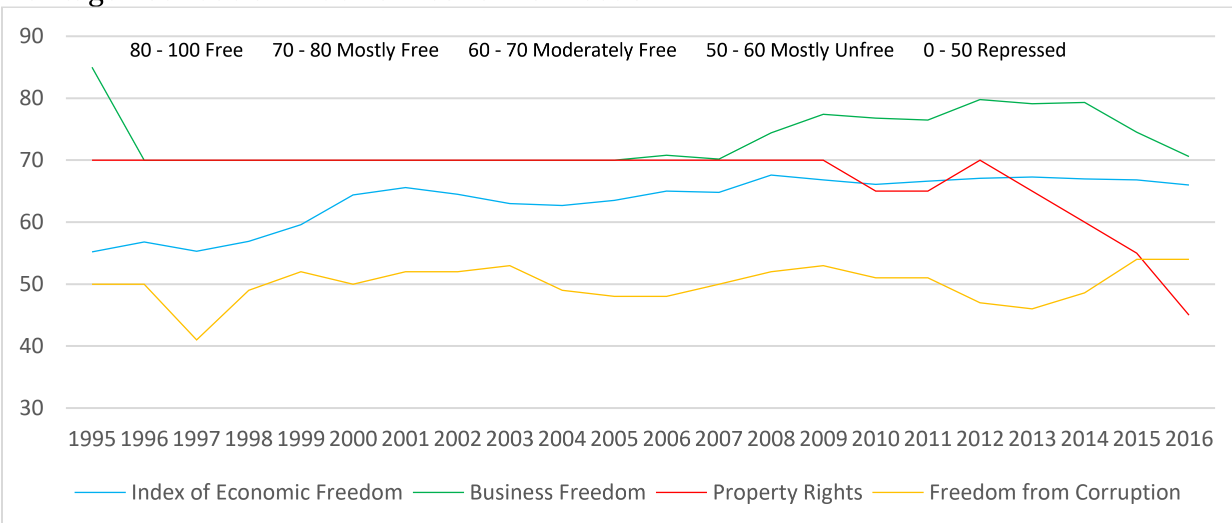
Year	Rank	Overall DTF	Starting a business -Rank	Starting a business -DTF	Starting a Business - Time (days)	Starting a Business - Cost (% of income per capita)	Dealing with Construction Permits-Rank	Getting Electricity-Rank	Registering Property -Rank	Getting Credit-Rank	Getting Credit - Strength of legal rights index (0-12)	Getting Credit - Depth of credit information index (0-8)	Getting Credit - Credit bureau coverage (% of adults)
2017	33	75.61	68	88.62	11.5	1.2	103	53	7	44	7.0	6.0	76.4
2016	30	75.44	64	88.54	11.5	1.5	102	47	5	42	7.0	6.0	67.3
2015		74.21		87.02	11.5	1.5					7.0	6.0	65.7
2014		71.03		85.25	18.5	1.5					7.0	6.0	61.6

Year	Protecting Minority Investors-Rank	Protecting Minority Investors - Ease of shareholder suits index (0-10)	Protecting Minority Investors - Extent of shareholder governance index (0-10)	Protecting Minority Investors - Extent of shareholder rights index (0-10)	Protecting Minority Investors - Extent of corporate transparency index (0-10)	Paying Taxes-Rank	Paying Taxes - Payments (number per year)	Paying Taxes - Total tax rate (% of profit)	Paying Taxes - Profit tax (% of profit)	Paying Taxes - Labor tax and contributions (% of profit)
2017	87	7.0	6.0	6.0	6.0	56	8.0	51.6	10.5	39.7
2016	85	7.0	6.0	6.0	6.0	58	11.0	51.7	10.5	39.7
2015		7.0	6.0	6.0	6.0		22.0	51.8	10.7	39.7
2014		7.0	6.0	6.0	6.0		22.0	49.3	6.8	39.6

Year	Enforcing Contracts-Rank	Enforcing Contracts-Rank12	Enforcing Contracts - Time (days)	Enforcing Contracts - Cost (% of claim)	Enforcing Contracts - Quality of judicial processes index (0-18)	Resolving Insolvency-Rank	Resolving Insolvency - Recovery rate (cents on the dollar)	Resolving Insolvency - Time (years)	Resolving Insolvency - Cost (% of estate)	Resolving Insolvency - Strength of insolvency framework index (0-16)
2017	82	82	705.0	30.0	10.5	35	55.6	4.0	18.0	13.0
2016	81	81	705.0	30.0	10.5	34	54.7	4.0	18.0	13.0
2015			705.0	30.0			54.4	4.0	18.0	13.0
2014			545.0	30.0			54.1		18.0	13.0

Figure 7.3: Hungary

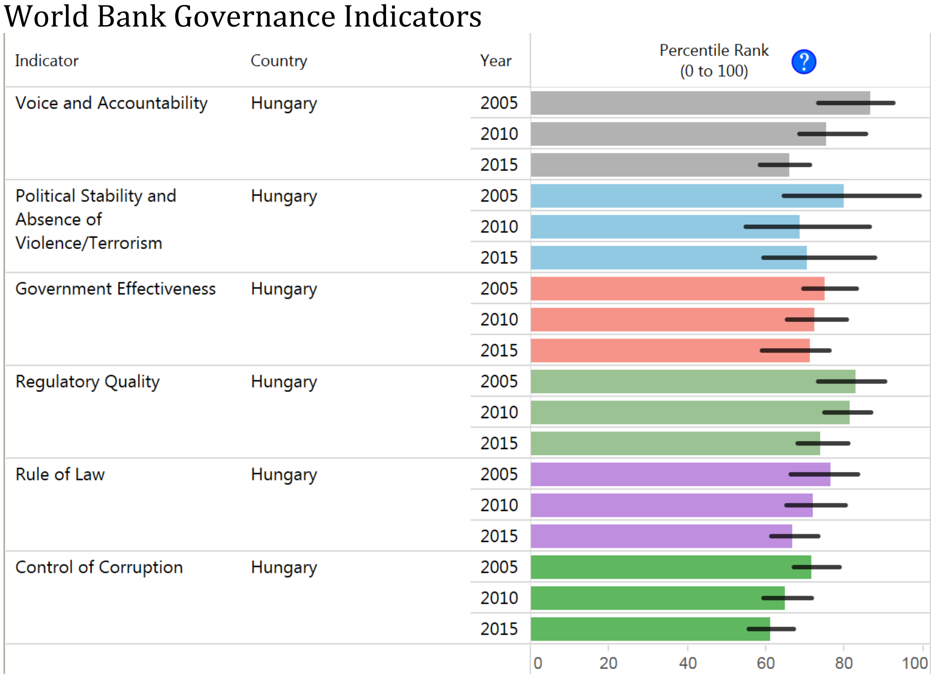
Heritage Foundation Index of Economic Freedom



Transparency International Perception of Corruption Index

	1998	2015
Global Rank	33	50

World Bank Governance Indicators



World Bank Ease of Doing Business

Year	Rank	Overall DTF	Starting a business -Rank	Starting a business -DTF	Starting a Business - Time (days)	Starting a Business - Cost (% of income per capita)	Dealing with Construction Permits-Rank	Getting Electricity-Rank	Registering Property -Rank	Getting Credit-Rank	Getting Credit - Strength of legal rights index (0-12)	Getting Credit - Depth of credit information index (0-8)	Getting Credit - Credit bureau coverage (% of adults)
2017	41	73.07	75	87.28	7.0	7.1	69	121	28	20	10.0	5.0	89.8
2016	40	72.74	71	87.10	7.0	7.5	66	118	28	19	10.0	5.0	88.6
2015		72.36		86.58	7.0	8.5					10.0	5.0	74.6
2014		66.92		89.32	7.0	8.8					6.0	5.0	73.2

Year	Protecting Minority Investors-Rank	Protecting Minority Investors - Ease of shareholder suits index (0-10)	Protecting Minority Investors - Extent of shareholder governance index (0-10)	Protecting Minority Investors - Extent of shareholder rights index (0-10)	Protecting Minority Investors - Extent of corporate transparency index (0-10)	Paying Taxes-Rank	Paying Taxes - Payments (number per year)	Paying Taxes - Total tax rate (% of profit)	Paying Taxes - Profit tax (% of profit)	Paying Taxes - Labor tax and contributions (% of profit)
2017	81	6.0	7.0	8.0	7.0	77	11.0	46.5	9.9	34.3
2016	78	6.0	7.0	8.0	7.0	79	11.0	48.4	11.8	34.3
2015		6.0	7.0	8.0	7.0		11.0	48.0	11.8	34.3
2014		6.0	7.0	8.0	7.0		12.0	49.3	12.3	34.5

Year	Enforcing Contracts-Rank	Enforcing Contracts - Time (days)	Enforcing Contracts - Cost (% of claim)	Enforcing Contracts - Quality of judicial processes index (0-18)	Resolving Insolvency-Rank	Resolving Insolvency - Recovery rate (cents on the dollar)	Resolving Insolvency - Time (years)	Resolving Insolvency - Cost (% of estate)	Resolving Insolvency - Strength of insolvency framework index (0-16)
2017	8	395.0	15.0	12.0	63	43.0	2.0	14.5	9.0
2016	13	395.0	15.0	11.0	63	41.7	2.0	14.5	9.0
2015		395.0	15.0			40.2	2.0	14.5	9.0
2014		395.0	15.0			38.3		14.5	9.0

Establishing a business environment

In the Czech Republic, private sector output, which according to the World Bank had accounted for less than 10% as a share of GDP in 1990, had grown to 65% of the GDP by 1995 and 80% of the GDP in 2000. The private sector represented 47.1% of all employment by 1993. In its 1995 Transition Report, the EBRD concluded that Czech Republic had achieved the highest rate of privatization progress in Central and Southern Europe. On a scale of 1 to 4, where 4 signifies conditions approaching those of developed market economies, the EBRD granted the Czech Republic a score of 4 across a range of indicators.

	Large scale privatization	Small scale privatization	Trade and foreign exchange	Effectiveness of legal regulations	Enterprise restructuring	Price Liberalization	Banking and securities market reform
1995	4	4	4	4	3	3	3

The EBRD noted that further progress was needed in developing competition policies consistent with EU guidelines, implementing anti-trust regulation, and creating bankruptcy procedures. Still, by 1995, the Czech Republic annually added 9.3 new enterprises, with a total business density of 45 firms, per 1000 inhabitants, well beyond the level of any other transition economy, and close to the EU average; and 0.76 patent and trademark applications per 1000 people. A quarter of new, private firms in this period were in the areas of manufacturing and construction.

In the early years of the transition process, the Czech Republic could boast few managers with experience and skill necessary to lead companies under a market economy; business education within Czechoslovakia under the communist regime had been virtually nonexistent, and individuals who obtained access to Western employment or education rarely chose to return. Research has repeatedly demonstrated that privatization to outside owners and the introduction of new management have a pronounced effect on firm productivity (Frydman et.al., 1999). Yet while the Czech voucher program led to a predominantly outside ownership of enterprises and consolidation of ownership initiated by the IPFs by 1995, largest firms appeared to experience the lowest rates of management turnover during the process of privatization. Thus, during the 1990s, productivity growth was sluggish considering the low levels of unemployment (Figure 4.9), with the exception of rapidly rising productivity in the industrial sector between 1994 and 1996. Personnel cuts, new management, and investment in labor-saving technologies were necessary across both the private and public sectors. Thus in the first two years of the transition, in preparation for announced privatization, and in the absence of strict employment-protection programs, 600 large state enterprises shed 30% of their work force, though they were reluctant to strip physical capital (Grosfeld and Roland, 1995). Firms that implemented early management turnover significantly outperformed industry peers in terms of both productivity and profitability (Claessens and Djankov, 1999a). Following intensified efforts by the Czech government to counter negative management trends following the 1997 crisis, labor productivity of the total economy rose quickly. The largest rise in value added per worker to the GDP was in manufacturing; unsurprising, considering the presence of foreign investment and ownership in the sector.

The World Bank Ease of Doing Business report, published annually since 2004 with rankings added in 2014, ranked the Czech Republic as 26th out of 189 countries in 2016 in terms of ease of business operations and the regulatory environment. However, although this rank cements its status as a regional leader, the Czech Republic does remain unfavorable in comparison to Western European states in some areas. Czech performance varies broadly across select indicators, and is particularly low in the areas of starting a business and the cost of paying taxes (Figure 7.1). The income to start a business has been reduced to some 5.7% of income per capita in 2016. Yet the number of procedures, and time to establish a business are significantly higher than the OECD average, although substantial progress has been made in all areas since 2004; and the process of obtaining construction permits is exceptionally slow and cumbersome. Registering property is appreciably less complicated.

Due to such issues in public administration and their effects on the private sector, in 2014, the Czech Republic was ranked 110th globally in terms of starting a business. However, in 2014, the government introduced two essential reforms that should positively affect the start of business operations: a new act on commercial corporations has abolished the minimum capital requirements for a limited liability company; and an act on public registers of legal and natural persons has enabled faster registration of entities. The time businesses need to comply with tax returns remains high, despite a recent decrease, and the while the corporate tax rate and profit tax are low, the total tax rate including labor tax and contributions stands at approximately 48% of profits (Figure 7.1). Finally, whilst the Czech Republic is only moderately behind the OECD average in terms of difficulty of trade as defined by customs procedures, and the time and cost required trade of goods, it has significant potential reduce business costs and facilitate trade by reducing the time necessary to process imports and exports.

At the formation of the independent Slovak Republic in January 1993, the Slovak industrial sector was characterized by a high concentration of economic activities in large state-owned enterprises; industrial production based in heavy industries with high consumption of energy and raw materials; low level of finalization of production; and low involvement in foreign trade. The private sector accounted for 32% of the GDP and 20% of employment in 1992 and

1990, respectively, a share that rose to 58% of the GDP, with 52% of the value added stemming from industry, and 40.5% of employment in 1994. It's enterprise density in 1995 stood at some 20 firms per 1000 inhabitants. However, the 1995 EBRD Transition Report awarded Slovakia an overall score of 3 on the scale of privatization, noting that while small scale privatization had begun to approach developed market conditions with a score of 4, the state lagged behind the European average, and many of its regional neighbors in terms of large scale privatization and enterprise restructuring.

	Large scale privatization	Small scale privatization	Trade and foreign exchange	Effectiveness of legal regulations	Enterprise restructuring	Price Liberalization	Banking and securities market reform
1995	3	4	4	4	3	3	3

The EBRD further warned that Slovakia would have to address the issues of price liberalization, competition policy, and banking, securities market and investment regulation reform to achieve the establishment of a secure, stable private enterprise.

Indeed, the biggest challenge to private sector entrepreneurship in this period resulted from deficiencies in the legal system, problems with enforcement of existing laws, and unwarranted government interference in the functioning of the market. Laws generally failed to adequately protect minority shareholders and ensure transparency in corporate governance, and contributed to the decline in the rate of private sector development through the protection of strategic enterprises. The virtual absence of bankruptcy proceedings undermined market discipline and inhibited the exit of unprofitable firms. Inter-enterprise arrears amounted to 18% of GDP in 1997, roughly unchanged from 1996. Although industrial employment fell sharply early in the transition, and productivity thus rose slightly between 1992 and 1994 (Figure 4.9), according to the EBRD, firm profitability remained low and, in the instance of larger enterprises, sharply deteriorated. Aggregate reported profits of non-financial enterprises fell by over 50% between 1997 and 1998. Aggregate profits in manufacturing were negative, with about 1,000 out of 2,300 firms above 20 employees reporting losses. Financial distress also led to an increase of arrears, reaching close to 20% of GDP at the end of 1998, up from 18% at the end of 1997. The manufacturing sector, by contrast, appeared to go against this trend, with labor productivity soaring by over 11% and value-added increasing by 5%. However, these developments were largely driven by the rapid expansion of car production at Volkswagen's subsidiary in Bratislava, rather than by general progress in enterprise restructuring. While the private sector consistently recorded faster output and employment growth than the public sector, and profitability rose in the largely private small enterprises, medium-sized and large remained under government or insider control, and posted an equal number of loss-making and profitable firms.

However, in 1998, with a renewed push toward privatization programs, a new Slovak government identified improving the business environment as a central cornerstone of its economic agenda. The legal system was significantly strengthened, and the reform process was deepened, leading to a substantial increase in the rate of enterprise restructuring, and a decline in the share of medium and large firms in the value added to the economy. The rising productivity and profitability of firms, particularly in the manufacturing sector, prompted remarkable growth of the state's economy, and the launch of a favorable competitive position through a range of connections to international financial markets, relatively high corporate profitability and high productivity growth. Prior to the financial crisis, the profit growth of the non-financial business sector in Slovakia was the highest in Eastern Europe, and far exceeded most developed Western

European states. Productivity between 1997 and 2008 averaged approximately 4.9% annual growth (Figure 4.9). The Slovak economy posted highest growth among the 27 member states of the EU throughout the decade following the 1998 reforms (Figure 4.2), and the productivity of the Slovak labor force relative to labor costs is one of the highest in the CEE region. The country's rapid economic development was additionally strengthened with the adoption of the Euro currency in 2009, the implementation of a flat tax system and preservation of the lowest debt ratio in euro area.

The relatively positive macroeconomic outlook since the crisis has allowed for high creation of new enterprises: new business density reached 5.11 in 2012, suggesting a healthy emerging entrepreneurial atmosphere. In the long term, however, labor costs, technological capability and productivity should converge with EU standards, and Slovakia will have to further catalyze private sector and productivity growth through business innovation, a consistent and fair corporate environment, and targeted investment. Unfortunately, due to weaknesses in research institutions, education and the innovation system, and low investment in R&D projects, the innovation capacity of domestic firms remains limited.

Recognizing the overall stability of the Slovak business environment, the World Bank Ease of Doing Business Index ranks Slovakia as a relatively business-friendly state (Figure 7.2): although its overall global rank of 33 in 2017 lags behind its Western European Eurozone counterparts, it remains one of the top performers in Eastern Europe. Much like in the Czech Republic, the quality of the business and regulatory environment differs sharply across indicators, with the strongest performance stemming from the financial and corporate sectors, and the lowest scores recorded on the institutional and government frameworks. On the whole, Slovakia's regulatory policy environment in regards to institutional capacity falls short of its Eurozone neighbors, and requires significant advancement. A comprehensive strategy to improve the business environment was adopted in 2011, and a number of measures were implemented between 2011 and 2013, although administrative burdens remain high.

Slovakia rose several places on the Starting a Business index between 2014 and 2016 as the time and capital necessary to launch a business both decreased, the latter to only 1.2% of income per capita. Obtaining construction permits and electricity for new businesses remains unduly difficult; by contrast, registering property is exceptionally straightforward. Further regulatory problems are evident across the business operations spectrum. Despite Slovakia’s extremely open economy, firm activity is obstructed by the high costs and time required for trade. The tax regime for private enterprise has lately been completely overhauled. As recently as 2015, businesses were required to devote a high number of hours attending to tax matters and complete 32 annual payments. Such an opaque and challenging tax regime created opportunities for corruption and tax evasion, and the European Commission believed that the Slovak government has limited powers to prevent tax fraud and recover unpaid taxes. However, by 2016, the number of payments had been reduced to 8, and other filing and payment measures vastly simplified the tax code. Revenues remain hindered by a high total tax rate that accounts for over 51.5% of total profits, principally due to high labor taxes and contributions.

Development indicators and reports from the first decade following the transition confirmed and corroborated Hungary’s status as a regional economic leader. Indeed, by 1995, the Hungarian EBRD transition scores matched those of the Czech Republic across virtually all dimensions.

	Large scale privatization	Small scale privatization	Trade and foreign exchange	Effectiveness of legal regulations	Enterprise restructuring	Price Liberalization	Banking and securities market reform
1995	4	3.7	4	4	3	3	3

The private sector share of GDP increased from 30% in 1991 to 80% in 1999, and cumulative privatization revenues rose from 0.1% of GDP in 1991 to 13% in 1999, largely thanks to foreign investors. Yet these assessments did not accurately nor fully capture Hungary's underperformance relative to its regional counterparts. In fact, the rate of progress was significantly slower than in Czechoslovakia; price liberalization had begun in earnest in the 1980s, and the Consumer Price Index stood at a mere 11% in 1991, as compared to 28% in Czechoslovakia. Enterprise reforms in both Hungary and the Czech Republic ranked highest among transitional economies by 1998, only a year after the Czech Republic faced an economic implosion driven in great part by shortfalls of privatization funds. Hungary, conversely, should have enjoyed the added benefits of restructuring under foreign ownership. Business density in 1995 stood at just under 35 per 1000 people, higher than in much of Central and Eastern Europe, but well below the Czech Republic.

Business Density per 1000 people	Czech Republic	Slovakia	Hungary
1995	45	20	35

Such comparisons appear to indicate that the efficacy and implementation of government programs designed to spur private entrepreneurship was notably slower in Hungary.

Still, in terms of external competitiveness, Hungary outperformed its Central European counterparts; manufacturing exports to the EU, which comprise the largest share of exports and formed the base of economic activity in Hungary, the Czech Republic and Slovakia in the 1990s, increased by 195.9% between 1995 and 2000, while increasing by 147.4% in the Czech Republic, and 127.1% in Slovakia (Oblath and Richter, 2002).

Manufacturing Exports to the EU, growth	Czech Republic	Slovakia	Hungary
1995-2000	147.7	127.1	195.95

Moreover, as the rise in exports outpaced growth of imports, Hungary achieved a positive trade balance with the EU by 1999, and the foreign trade surplus has continued to expand even since the financial crisis (Figure 4.17). Initially, the growth in exports was principally fueled by two factors: a labor cost advantage relative to regional competitors after the reduction of real wages in the second half of the 1990s, and large productivity gains. Hungary maintained a low unit labor cost among CEEC states, higher only than that of Bulgaria and Romania, at approximately 20% of an EU reference country (Austria). By contrast, unit labor costs in the Czech Republic matched around 30% of an EU reference country. International competitiveness was further advanced by productivity growth that averaged 15.7% throughout the 1990s, as compared to 11% and 6% growth in Slovakia and the Czech Republic, respectively (Figure 4.9). Productivity growth was particularly high in the industrial sector, spurred by a decline in employment, which accounted for 40% of the total productivity growth.

Nevertheless, these advances in productivity, competitiveness, and foreign direct investment could not be translated into concrete and lasting gains, as they were catalyzed by privatization to external owners rather than any noteworthy restructuring of the domestic markets. By 1997, foreign-owned companies produced about one third of GDP and accounted for some 25% of private sector employment, while output in those sectors received the greatest share of FDI and, accordingly, investment. Direct corporate control by foreign owners has been effective in alleviating ‘agency problems,’ and has subdued corporate governance malpractices that have been common across other post-communist countries. The performance of domestic firms, and the domestic institutional environment has on the contrary lagged behind regional averages, facing continued poor business infrastructure; bureaucratic obstacles; difficulties in restructuring and modernization; lack of medium and long term finance. The disconnect between efficiency of domestic and foreign owned firms has widened in the past decade; in 2013 foreign controlled enterprises provided more than 50% of value added to the Hungarian economy despite encompassing slightly more than 25% of employment. In the Czech Republic, with similar levels of employment stemming from externally owned firms, their value added to the total GDP stands at approximately 42%. In Slovakia, the gap is yet smaller, as foreign controlled businesses contribute 36% of value added to the GDP, and 22% of employment.

Due to the continuing strength of the some sectors of the Hungarian economy, the World Bank Ease of Doing Business Index placed the state 41st in terms of Ease of doing business in 2016, which has widened the gap between Hungary and its regional competitors (Figure 7.3). Interestingly, administrative processes remain more efficient than in the Czech Republic and Slovakia. Yet unlike both the Czech Republic and Slovakia, the ease of starting a business in Hungary has diminished in the last four years. Both the time and cost, which equals some 7.1% of income per capita, to establish a business remain conspicuously higher than the OECD norm, and the latter has risen with the deployment of new registration taxes and payments. This obstruction in the formation and advancement of new businesses has resonated among investors and firms. As early as 2005, the EBRD (2005) reported that businesses believed access to finance, tax administration, the functioning of the judiciary, and business regulation to be greater impediments to private sector activities than at the turn of the decade. With investor confidence continually on the decline since the financial crisis, the World Bank's assessment of starting business operations is perhaps surprising only because it does not appear to adequately capture the deep rooted pessimism within the Hungarian business community. According to the World Bank (2016), 41.8% of Hungarian businesses reported state intervention in firm decisions, as compared to 20% in the Czech Republic, and 43.4% in Slovakia.

Institutional stability and regulatory frameworks

Forming and developing effective regulatory frameworks necessary for the sustainable advancement of economic growth has proven to be the greatest challenge for Central European states. On the whole, administrative systems across the region have been burdened by inefficiency, corruption, and wastefulness, and, according to the Heritage Foundation Index of Economic Freedom (2016), enjoy the lowest public confidence of any state sector. Such administrative insufficiencies have undoubtedly produced spill-over effects into the economy, and regulations that should promote competitiveness and capacity of private enterprises have generally fallen short across the Czech Republic, Slovakia, and Hungary. Certainly, the former two have recently been better able to build capacity in public administration areas most relevant to business: exit mechanisms and bankruptcy proceedings, competition law and private property protections, and anti-corruption measures. Interestingly, at the start of the transition, Hungary enjoyed the greatest tradition of codified regulatory statutes, and attempted to quickly implement a comprehensive regulatory system to support the new market economy. Yet Hungary's reluctance to push a liberalization and privatization agenda likewise created an incentive towards a shadow economy, and the state has hence been marred by insidious and persistent corruption, both in the public and the private sectors. The Hungarian experience indicates that proper administrative frameworks cannot be the sole or primary drivers of economic growth in the absence of inclusive and vibrant free market entrepreneurship.

In sharp contrast, on the whole, Czech and Slovak economies have succeeded in spite of, rather than due to, public institutions and regulatory environments. Under such conditions, the importance of private sector stewardship of the economy is especially highlighted. Where public organs and directives are slow to respond to reform efforts, and remain mired in – at best – ineptitude, and, at worst, outright bribery, fraud, and rent-seeking behavior, economies that shift management of enterprise to private businesses and individuals, and implemented programs that generated widespread participation in the new private sector, as in the Czech Republic, may be better positioned to catalyze and sustain economic growth.

Creating exit mechanisms

In the Czech Republic, initial insolvency regulation adopted in 1991 effectively prevented the possibility of external creditors forcing low performing firms into bankruptcy. The law was amended in 1993 to grant creditors legal recourse through bankruptcy proceedings following a three month protective period, although private farmers remained protected from bankruptcy until 1994. Nonetheless, bank ownership of investment funds that held enterprise portfolios, so amalgamating managers and debt-holders, undermined corporate governance and pursuit of bankruptcy measures. Between 1992 and May of 1995, a total of 4500 bankruptcy petitions had been filed, and only 600 declared. While the Bankruptcy and Composition Act was amended each year between 1996 and 1998, and again in 2000, to place time limits on bankruptcy filings and final liquidation procedures, and to assist creditors in liquidating debtors' assets, creditor-led bankruptcy was infrequent, and the government initially remained reluctant to accept the political and social implications of large-scale bankruptcies.

In 2005, a new Bankruptcy law, spurred by impending accession to the European Union, the Czech Republic strengthened creditor rights, expedited procedures, and dramatically overhauled the insolvency process. The World Bank (2016) reported that in 2004, the average time to complete an insolvency procedure was 9.2 years; the recovery rate on a dollar was 15.4 cents (Figure 7.1). By 2014, the time necessary to resolve insolvency was reduced to 2.1 years, and the recovery rate increased to 65.6 cents on the dollar. The Czech distance to frontier, defined as best observed country performance, as measured by the World Bank Ease of Doing Business jumped from 16.58 to 77.5 in that period. The improvement of bankruptcy procedures has received a great deal of attention from the Czech government, and progress in the area has been considerable: of the Ease of Business indicators, the Czech Republic scored the highest in terms of resolving insolvency,. According to World Bank data, legal amendments that transformed the insolvency framework in 2005 have been successful in ameliorating all stages of the insolvency process, from initiation of proceedings, to the management and reorganization of debtors' assets, although creditor participation requires further enhancement. Still, recourse available to borrowers and lenders under bankruptcy and collateral laws remained comparably weak, and the Czech Republic has yet to make significant strides in safeguards offered to minority investors (Figure 7.1)

In Slovakia, longer-term reforms introduced in 1998 aimed to improve the investment climate through legal and institutional changes designed to minority shareholder rights, contractual security and corporate transparency. New bankruptcy legislation enacted in August 2000 considerably strengthened creditor rights, simplified existing rules and introduced stricter criteria to trigger bankruptcy. The amended law aimed principally to speed up the bankruptcy process; prior to 1998, insolvency proceedings could take 18 months or longer to complete. Furthermore, the Insolvency Act created a quicker, more creditor-friendly regime that emphasized restructuring rather than liquidation and expressly provided for the possibility of a US "Chapter 11" style 'cram down' of a dissenting minority of creditors in order to achieve a restructuring plan. However, performance of the court system, characterized by few experienced judges and a large backlog of outstanding cases, remains a burden on the legal system. Out of more than 6000 insolvency proceedings that were initiated in 1999, only 659 bankruptcies were actually declared. Moreover, "strategic" enterprises and enterprises under the new "revitalization" program were excluded from the new legal regime.

In 2006, Slovakia introduced a new Act on Bankruptcy and Restructuring with two distinct commercial insolvency procedures: bankruptcy; and restructuring, which could be initiated and carried out with agreement from creditors and a court. The Act sets out judicious commencement criteria and processes, and provides protections to creditors during the observation period. The EBRD Insolvency Sector Assessment concluded that the Act was in "medium compliance" with best international practices and meets a generally acceptable standard, with commencement of proceedings and treatment of estate assets the strongest, and liquidation and reorganization processes the weakest, features of the insolvency framework. The Assessment noted that the legal implementation of bankruptcies could be further ameliorated by specialized insolvency courts.

The World Bank has also recognized improvements in Slovak efforts to facilitate bankruptcy proceedings, ranking the state 31st in 2015. The insolvency framework has been strengthened and procedures simplified: in 2013, Slovakia amended its insolvency process by elucidating the role, and strengthening the rights of creditors; and amending rules for the shift from restructuring negotiations to a bankruptcy proceedings. The recovery rate of assets has improved over the last decade, from 39.8 cents on the dollar in 2004, to 54.4 in 2015, although it remains low (Figure 7.2). Concurrently, enforcement of contracts has somewhat improved due to modifications of the code of civil procedure designed to simplify proceedings and limit obstructive legal tactics. The government has announced that further reforms will be considered and enacted in the near term. Enforcement still remains encumbered by slow speed and high cost of reaching judgment. Safeguards for minority investors, conversely, are extremely inadequate and deteriorating because of extremely weak regulation, and a lack of corporate transparency (Figure 7.2).

In 1992, Hungary introduced an innovative bankruptcy framework with two distinct tracks: liquidation, and re-organization, which was triggered automatically with the failure to comply with payables within 90 days, and allowed companies time to renegotiate debts and begin restructuring. This option was created in an attempt to shield banks against an increase in nonperforming loans; preserve struggling enterprises whose liquidation value was low due to a lack of secondary markets; and protect the state's ability to extend credit to firms, and tolerate large volumes of tax arrears. In practice, liquidation was the chief recourse for restructuring firms after 1992; although re-organization was seldom activated, it may well have contributed to the credit crunch and output decline in the early 1990s (Bonin and Schaffer, 2002). As the re-organization mechanism was based on measures of illiquidity rather than insolvency, profitable and viable firms could be subject to its provisions if they carried overdue claims. Within the first few months of the law's enactment, the number of automatic reorganization filings rose so rapidly that the government abandoned the trigger by the following year. Virtually no re-organization plans were subsequently voluntarily filed, and some 70% of firms that had completed re-organization tracks before 1993 were forced to pursue liquidation within two years, as structural changes were rarely implements, and as the state continued to prop noncompetitive firms. Close to 60% of the claims on firms during the transition period were in the form of tax arrears and social security payments.

Hungary's early attempts to establish prudent bankruptcy proceedings thereby did not result in the removal of underperforming firms from the market, nor spur the removal of government support for such enterprises. The government has not introduce significant amendments to the initial bankruptcy law despite mounting pressures to reform the process. Since 2008, due to the rise of bad debts and scarcity of credit, coupled with former low financing costs and lending standards, over-leveraging of businesses, and unwarranted securitization activities, almost all bankruptcies have ended in liquidation. In 2009, the EBRD's Insolvency Law Assessment rated Hungary's general bankruptcy regulations as falling within "Medium Compliance" with European standards. While the World Bank (2016) has rated Hungary's legal framework as moderately strong (Figure 7.3), the EBRD (2009) warns considerable material gaps within re-organization proceedings that dissuades creditors and debtors from engaging in negotiated settlements and restructuring. Most problematically, the World Bank estimates that less than 1% of companies that enter into insolvency proceedings continue operations, and business rescues are exceedingly rare. In 2010, the World Bank conferred with Hungarian officials on means to improve the insolvency regime; at present, no recommendations have been adopted.

The World Bank Ease of doing business rates Hungary as 63rd on its Resolving insolvency index, noting that the time, and particularly the cost, of settling bankruptcy claims exceeds the OECD average (Figure 7.3). Moreover, the Hungarian government has not made real progress in advancing logistical insolvency issues: although the recovery rate of claims has risen slightly in the past decade, the time and expense has not been reduced. Creditors are shut out from participating in re-organization and insolvency proceedings, and the recovery rate is a mere 43 cents on a dollar. The strength of minority shareholder protections is similarly weak. While shareholder rights, governance, and corporate transparency are all judged to be above average, conflicts of interest are poorly managed, and directors are not held liable for firm performance, complicating attempts to bring claims against managers.

Competition law and private property

In 1991, the Czechoslovakian government introduced the state’s first Competition Law to promote competition and limit abuses of monopoly powers and advise on mergers through the Office for the Protection of Economic Competition. The Commercial Code was amended in 1996 to increase shareholder protections. In 1997, the EBRD (1999) thus awarded the Czech Republic a score of 4 on extensiveness and effectiveness of company law. However, enforcement of anti-competition provisions lagged throughout the decade. In 1999, the EBRD (1999) lowered the Czech legal rating to 3, as limitations in the scope and enforcement of the commercial code became apparent, particularly in regard to protections extended to foreign and minority shareholders. Starting in 1995, the first year of the measure, Index of Economic Freedom published by the Heritage Foundation has consistently classified the Czech Republic as mostly free (Figure 7.1), noting that although comprehensive legal protections are in place, the state has been burdened by delays in the court system, and lenient enforcement mechanisms.

The World Bank's World Governance Indicators project, published biannually from 1996 to 2002, and annually since 2003, reports on the selection, capacity, effectiveness and responsiveness of governments, across six critical markers on a scale of -2.5 (weak) to 2.5 (strong governance). The Czech Republic has commonly received mid-range marks for Rule of Law, a measure that reflects confidence in the quality of contract enforcement, property rights, and police and judicial effectiveness, among other indicators (Figure 7.1). It has thus ranged between the 67% and 85% of all the states surveyed. The Czech score for Regulatory Quality, which reflects ability of the state to formulate and execute sound policies and regulations that permit and promote private sector development, has been somewhat higher.

According to the EBRD, in 1999, 55% of Czech firms had at least some doubts about whether the legal system would protect the security of their property and contract rights, and more than 20% of firms reported impact from state capture. Perceptions of economic governance, ranging from judiciary to customs and labor regulations, by firms continued to worsen through 2005. Although redress mechanisms available to minority shareholders and their enforcement became increasingly effective, the time needed to conclude proceedings often exceeded two years. The time and number of procedures to enforce contracts has been reduced only marginally in the last decade. The extent of disclosure, corporate transparency and director liability remains extremely low. Since 2011, the Czech Rule of Law score has risen above 1.0. Correspondingly, the enforcement of contracts has been improved as the Czech Republic adjusted its civil procedure code to simplify and accelerate the execution and enforcement of judgments, though it remains sluggish and costly; the state is rated 68th globally on this Ease f doing business index. Corporate transparency and the strength of corporate governance remain particularly problematic and vulnerable to corruption, with little sign of impending improvements. Indeed, in contrast to the 2013 law that attempted to eradicate anonymous shareholders, a new citizens' code enacted in 2014 introduced a new form of ownership – trusts – with limited transparency about the users and beneficiaries of revenues from property, including shares.

Nonetheless, the EBRD (2016) reports indicate that business confidence, defined as the level of optimism of firm managers about the performance prospects of their own enterprises as well as economy performance, and measured as a weighted average of adjusted confidence variables in industry, construction, trade, and selected services, has been high since the start of the transition.

	1993-1999	2000-2004	2005-2007	2008-2012	2015
Business Confidence	84.93	98.88	102.7	88.98	94
Consumer Confidence	71.68	89.91	101.36	84.96	104.86

With the exception of dips caused by the 1997 and 2008 financial crises, business confidence has stood at over 90% since 1995, and even during periods of recession stabilized at over 70%. Likewise, consumer confidence – defined as the expected financial situation of consumers, expected total economic situation, expected total unemployment and expected in the upcoming 12 months – has proven exceptionally strong. In spite of failures of public administration systems, businesses in the Czech Republic believe they will be able to develop and prosper in the Czech private sector, implying a stable business environment.

The 1991 Czechoslovakian Commercial Code was amended several times in order to bring it in compliance with the relevant *acquis communautaire* in May 2004 as required by European Union. Slovakia has complemented this Code with several pieces of legislation targeted at particular sectors. Nonetheless, according to the World Governance Indicators, Slovakia has somewhat struggled to establish confidence in the rule of law as it pertains to private property regulations and protections; the state's aggregate Rule of Law score in 1996 stood at merely 0.15, which may well have reflected doubts about the direction of economic development in the context of halted privatization and liberalization efforts (Figure 7.2). However, Slovakia's score began to rise in 1999 as a consequence of a revitalized commitment to the opening and stabilization of the economy. Accordingly, the EBRD's 1999 Business Environment and Enterprise Performance Survey reported that some 35% of Slovak firms expressed doubt about the ability of the legal system to uphold contract and property rights, and 24% reported impact from state capture. Since the crisis, the confidence in the Rule of Law has remain stable, albeit somewhat lower (Figure 7.2). Slovakia's Regulatory Quality, as measured by the WGI, has followed the same pattern.

In 2007, the EBRD Corporate Governance Sector Assessment found that corporate governance legislation in Slovakia is in "high compliance" with international standards. The corporate governance framework and role of stakeholders were judged to be the most effective parts of the legislative framework, while the responsibilities of the board and equitable treatment of shareholders showed room for substantial improvement. Conversely, since 1996, the Index of Economic Freedom has classified Slovakia as "mostly unfree" in terms of property rights protections, noting that while interests in property and contractual rights are enforced, the court system continues to be "burdened by corruption, intimidation of judges, and a significant backlog of cases."

With waning commitment to privatization and market competition in the early years of Slovakian independence, according to the EBRD, business confidence stood at between 0 and -26 from 1993 to 1996.

	1993-1999	2000-2004	2005-2007	2008-2012	2015
Business Confidence	1.26	6.12	8.11	-3.46	1.8
Consumer Confidence	-22.26	-31.13	-7.84	-25.4	-11.85

As a pro-free market government took power in 1998, business confidence rose significantly, and averaged close to 10, reaching an all-time high of 22 in 2007. The crisis drastically damaged business confidence levels; since 2012, it has been on a slow if progressive rise, and is expected to continue the upward trend over the next several years. Consumer confidence has for the most part mirrored this trend: while it has been negative every year since 1993, with the exception of 2007, it rose steadily between 1999 and 2007, and again since 2012. The Heritage Foundation has rated Slovakia as mostly free in terms of Business Freedom, noting that progress has been made in streamlining the process for launching a business (Figure 7.2). Still, other time-consuming requirements and rigid labor conditions reduce the efficiency of the regulatory system.

Private law was first codified in Hungary in 1959, and drew on several proposals dating back to 1928, before communist central planning had taken root. Consequently, the commercial code was based in a free market system, and as such, was not identified as requiring immediate attention during the first years of the transition. Competition law, too, was introduced several years into the transition, and in 1996, the state ratified a law governing unfair market practices, restriction of competition, and anti-trust regulations. By 1997, the EBRD had granted Hungary the highest score of 4 for extensiveness and effectiveness of company law. Still, 1998, the government called for the formation of a formal ‘Codification Committee,’ comprised of judges, academic, and government officials, tasked with drafting a new commercial code. The Committee presented an initial concept in 2003, which the government confirmed and modified by 2006. The influence of the *acquis communitaire* was evident throughout the Code. The final text of the law was not agreed upon until 2013, and the updated Code finally went into effect in 2014, a decade and a half after its conception. The new regulations outlined broader latitude for shareholders to define company rules of operations, and offered somewhat vaguely worded constraints on contractual freedoms.

Despite lags in Hungary’s adoption of appropriate legal structures following the transition, prior to the financial crisis of 2008, the state had consistently been highly judged in the area of economic law. The EBRD’s assessments of commercial and financial laws in Hungary has found legislative frameworks to be in high compliance with international standards in the fields of public procurement, corporate governance, and the securities market, though progress is needed in concessions legislation. The EBRD (2007) assessment on corporate governance deemed Hungary to be in “High Compliance” with the OECD standards, and finding “no evidence” of major inadequacies in the pertinent frameworks, awarded it the highest ranking of any EBRD country of operation. The World Bank Governance Indicators granted Hungary scores similar to those of the Czech Republic on the Rule of Law index (Figure 7.3), and Hungary’s score for Regulatory Quality rose appreciably. Since the financial crisis, Hungary’s Governance indicators have consistently and markedly slipped. The Index of Economic Freedom has categorized Hungary as “repressed” in protection of property rights since 2014, despite maintaining its classification of moderately free in terms of business freedom, reflecting concerns about targeted taxes and state intrusion into the economy, including in key sectors of energy and banking (Figure 7.3).

This represents a remarkable swing from protections offered to businesses during the transition. In 1999, less than 30% of Hungarian firms believed the state would fail to uphold their contract and property rights, and less than 10% of firms reported impact from state capture despite very high reported state intervention in employment and wages (EBRD, 1999b). Enforcement of contracts has been deemed by the World Bank Ease of doing business to quite high in Hungary, and continues to be positively rated in disparity with Freedomhouse conclusions, with a global rank of 13 in 2015, primarily thanks to the quality of judicial processes in contract disputes. Such discrepancies in data and analysis may be attributed to the growing uncertainty over Hungary’s development path, and institutional or legal regulations. The signal from Orbán that the state will continue to identify possible sectors and industries for heightened government control has thrust insecurity into the Hungarian regulatory system, even where the existing frameworks provide adequate and effective protections.

The confirmation of this anxiety may be found in the exceptionally low business confidence in Hungary. Business confidence since the transition has varied sharply, after surging in the aftermath of the Bokoros package in 1996 (EBRD).

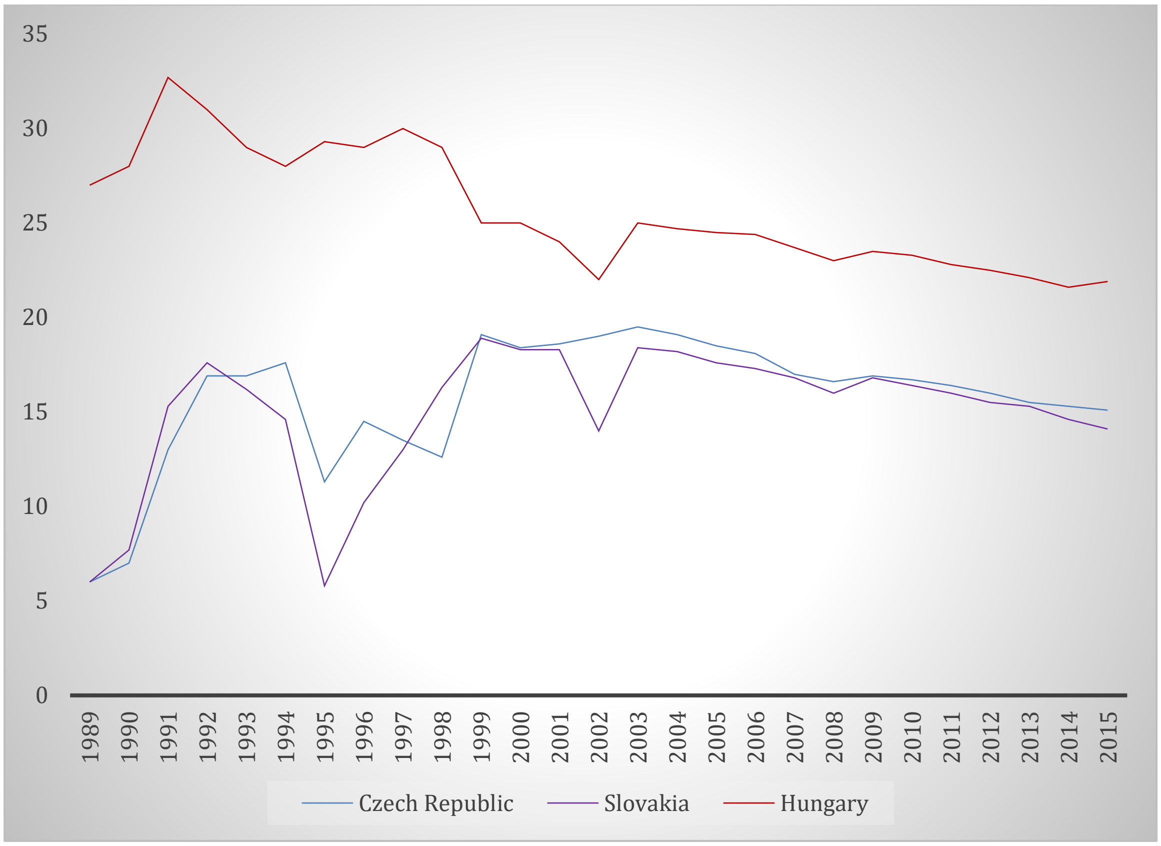
	1993-1999	2000-2004	2005-2007	2008-2012	2015
Business Confidence	-2.63	-6.32	-8.27	-13.34	4.88
Consumer Confidence	-25.7	-22.09	-37.39	-47.09	-14.88

Since 1998, however, it has been predominantly negative, even in times of strong economic growth, and plummeted to -37.7% at the height of the financial crisis in 2008. Although business confidence experienced a period of recovery in 2011, and 2013, it has struggled to rise past 5%, and appears to be taking a downturn in 2016. Consumer confidence has been correspondingly and overwhelmingly low; negative since 1996, it fell to -72% in 2009, and has remained at approximately -20% since 2012 save for a brief and dramatic rise in 2015, when both household financial outlook and employment prospects improved. Yet this spike in consumer confidence was so unmatched and ephemeral, it almost appears as an anomaly in the data. The conviction of Hungarian firms and consumers in the strength of the economy thus elucidates persistent weaknesses in the entrepreneurial sector not immediately manifest in other data.

Anti-corruption efforts

Corruption was endemic under the Soviet communist system; Czechoslovakia and Hungary were not spared the relatively high corruption rates, and have struggled with the legacy of pervasive corruption. Ending economic crime has been a stated principal objective of every successive Czech government. Yet data reveals a more positive depiction of corruption in the entrepreneurial sector. The share of the unofficial economy in the GDP in 1989 stood at a mere 6% (Figure 7.4), reflecting deep state repression of economic activity in Czechoslovakia (Kaufmann and Kaliberda, 1990). By contrast, the share of the unofficial economy was much higher in the lesser regulated economies of Hungary, at 27%, and Bulgaria, at 22.8%. However, following independence, it quickly rose to 16.9% before dropping to 11.3% in 1995. Twenty years later, the share of the shadow economy in the Czech GDP stands at 15.1%, below the EU 28 average of 18.3%, indicating a level of fiscal discipline and a solid tax and employment regime among the Czech population. According to the EBRD, the VAT tax gap, estimated as a revenue loss due to tax avoidance, fraud and evasion, bankruptcies and financial insolvencies, and miscellaneous miscalculations were 16.1% in 2014, only slightly higher than the EU average.

Figure 7.4: Share of Shadow Economy in the GDP



Source: OECD

Corruption in the Czech public sector remains a far more endemic issue. While legal instruments to combat corruption have been firmly in place since Czech independence, the rate of successful prosecutions continues to be low. Transparency International Corruption Perception Index ranked the Czech Republic as 37th out of 85 states in terms of perceived public sector corruption in 1998, the first year for which figures are available (Figure 7.1). Admittedly, Czech levels of state capture in 1999 were relatively low as compared with other nations in Central and

Eastern Europe. Still, the Czech Republic has commonly received the lowest governance score on the World Governance Indicators for the Control of Corruption index that reports on the degree of state capture, and the perception of the extent to which public power is diverted towards private interests. The Czech WGI score has generally placed the Czech Republic in the mid to upper 60th percentile for all states (with 100 being the highest rank), reflecting the high levels of corruption both within the region and globally (Figure 7.1). Firms reported highest rates of state intervention in the areas of investment, employment, sales and wages.

Accordingly, the Heritage Foundation's IEF has rated the Czech Republic as repressed or mostly unfree in terms of freedom from corruption from 1995 to present day. In slight contrast to the World Bank WGI data, the Heritage Foundation estimates that corruption levels appeared to reach their zenith in the early 2000s, particularly in 2004, and have improved somewhat since 2008. Transparency International's December 2011 National Integrity Study for the Czech Republic, intended to asses the ability of state institutions to address corruption, indicated that the "weakest pillars" are the state administration and the state's attorney's office, followed by the police. Excessive politicization of corruption cases had led to reluctance to actively move forward with corruption cases with a political subtext. In the World Economic Forum's Global Competitiveness Report 2013-2014, surveyed business executives cited corruption as the most challenging factor of doing business in Czech Republic.

In an effort to further mitigate corruption-related risks in both the private and public sectors, in April 2012, a substantially amended Public Procurement Act introduced additional transparency safeguards through stricter rules for publishing tenders and public contracts. Nevertheless, implementation of the new rules has proven difficult, in particular due to the still-inadequate administrative capacity and lack of guidance or training for staff responsible for applying the measures. In late 2013, the government adopted an amendment to the 2012 Act, increasing the financial thresholds above which public contracts are subject to public procurement rules. In 2010, the Czech government adopted a program entitled "Effective Public Administration" in an attempt to formalize regulations, systemize procedures and monitor implementation of public administration and public services. However, the quality and efficiency of the Czech public administration remains a challenge, with negative repercussions on the growth performance of the Czech economy.

Most problematically, according to the 2014 EU Anti-Corruption Report, 71% of Czech businesses believe corruption to be a major obstacle to doing business, and 69% point to patronage and nepotism as obstacles, among the highest figures in the EU. World Economic Forum analysis concludes that the perception of public-fund diversion is also one of the highest in the EU. In the political arena, lobbying is not regulated; the procedures for financing political parties and election campaigns are not sufficiently transparent; and prosecution of corruption in the private sector is almost non-existent. Progress in the fight against corruption has been limited due to an absence of clear political commitment and ownership, and key measures have been repeatedly delayed.

In Slovakia, the shadow economy has not had a major impact, particularly in comparison to other Central and Eastern European states. After reaching 17.6% of the GDP in 1992, the share of the unofficial economy dropped to 5.8% in 1995, far lower than in the Czech Republic or Hungary (Figure 7.4). Nevertheless, the low share may well be attributed to a slowing of the privatization process rather than inherent strength of the Slovak regulatory regime. As privatization began to accelerate in the late 1990s, the Slovak unofficial economy share rose to levels comparable to those of the Czech Republic. Still, despite proving successful at suppressing shadow economy activity, Slovakia remains faced with serious corruption challenges. The VAT tax gap is among the highest in the EU, at almost 30% of the GDP in 2014.

Transparency International Corruption Perception Index ranked Slovakia 48th out of 85 states in 1998, marking it as 35% “clean.” Slovakia has somewhat improved in the last decade and a half, and now stands immediately behind the Czech Republic in terms of corruption according to the Index (Figure 7.2). The state’s rank dipped between 2000 and 2003, coinciding with sales of major state enterprises, but has since recovered and risen, as Slovakia has continued to pursue policies conducive to private sector growth. Matching a trend among its Central and Eastern European counterparts, the lowest of the six Slovak WGI indicators is for Control of Corruption (Figure 7.2). Despite efforts to curtail corruption, Slovakia remains categorized as “repressed” in terms of freedom from corruption according to the Heritage Foundation’s Freedom in the World Index (Figure 7.2) due to a focus on administrative, rather than business activities and issues.

The greatest challenge to corruption efforts remains in the judicial branch, which has undermined effective enforcement of commercial rules. Judicial and enforcement proceedings commercial cases are excessively long, and professed judicial independence is the lowest in the EU. The legal system is still burdened by a lack of judicial expertise and an inconsistent court and appeals process in commercial and competition law; the resulting high number of active and pending commercial cases has led to delays in legal recourse and compensation. Corruption offenses in the private sector are infrequently prosecuted: despite greater transparency, irregularities in public procurement procedures persist, and both the number of registered bids is among the lowest in the EU, demonstrating low public procurement competition. The 2014 Code of Civil Procedure has attempted to address some of these issues, and may produce success in coming years.

In 2013, Slovakia significantly amended the Public Procurement Act and strengthened the Public Procurement Office to streamline lengthy tender procedures, improve transparency requirements and enhance competition. The EBRD has judged the Act to theoretically be in high compliance with EU standards, although Slovakia remains “moderately effective” at implementation of the relevant regulations. The Assessment noted that competition and uniformity are the strongest, and efficiency of the public contract the weakest feature of the state’s regulatory framework in the public procurement sector. Stability and flexibility are the strongest, and proportionality the weakest feature of the public procurement practice. Specifically, despite the government’s strong institutional capacities, local procurement practice has been reported as bureaucratic and suffering from implementation gaps. Moreover, while the European Union has pronounced that progress in the field of judiciary independence and efficacy has been evident since 2012, human and institutional administrative capacity will undoubtedly require further development and reform.

In 2012, the new Slovak government adopted an important reform of the public administration with implementation measures spanning the period of several years. The main objective of the initial phase of the reform is to streamline the organizational structure of local and district level state administration. Ministries and central government bodies are expected to undergo functional audits to identify duplication and optimize internal processes, leading to a modernization of human resources management to be completed at a later date. Accordingly, the European Commission has warned that Slovak reforms have not adequately tackled central government flaws. Slovakia suffers from high staff turnover rates linked to the political cycle, which undermines administrative independence and weakens the state's analytical capacities; insufficient aptitude for evidence-based agenda setting; and a lack of a clear framework regulating lobbying activities. According to the EU Anti-Corruption Report, in 2014, 90% of Slovakian citizens believed political corruption to be widespread, 66% of Slovak businesses considered corruption to be an obstacle for private sector development.

In Hungary, the share of the unofficial economy in the GDP has been persistently high. By 1992, the shadow economy exceeded 30% of the GDP, a share remains well above the EU average (Figure 7.4). Two thirds of the value of the hidden economy is unregistered labor, while the remaining third arises from tax evasion. The VAT tax gap in 2014 stood at approximately 18%, after falling more than 4 points since 2013. A lack of confidence in government, a complicated tax system, and a pre-communism legacy of unofficial business activities have most significantly contributed to the persistence and volume of the hidden economy, with construction, retail, manufacturing, tourism, and personal services comprising the particularly vulnerable sectors. Hence, anti-corruption efforts in Hungary have yielded little benefit. In 1998, Transparency International ranked the state 28th out of 85 countries, with a 50% "clean" score. Since then, the Hungarian rank has remained largely stagnant (Figure 7.3). It has been rated as "mostly unfree" by the Heritage Foundation Index since independence. Interestingly, however, while the Transparency International data shows slight improvements in Hungarian corruption scores, the World Government Indicators reach a contrary conclusion. Due to recent economic developments that have drastically undermined the freedom of business activities and the confidence in public support of the private sector, the WGI Control of Corruption score for Hungary has drastically declined from a high of 0.69 in 2000, to 0.13 in 2014 (Figure 7.3). While Hungary has implemented a number of tools to increase integrity and transparency in public administration, informal relations between firms and political actors continue to undermine both the public and business sectors. The 2013 EU Anti-Corruption Report has asserted that 89% of Hungarians believe domestic corruption to be widespread, and 13% have purportedly been asked or expected to pay a bribe in the past year.

While corruption in the Czech Republic and Slovakia mostly centers around the judicial and administrative branches, and the use and direction of public funds, corruption in Hungary has permeated the business sector. An astonishingly high number of companies, especially SMEs, engage in "subsistence" corruption that allows them to remain operable by retaining profits through the avoidance of taxes. In part, this is due to cumbersome and changing tax levels and procedures; Hungary has one of the highest levels of labor tax in the region, and the legislative tax regime has often been in flux. Public procurement remains vulnerable to irregularities at the local level because of strong informal relations between businesses and political actors. Moreover, although a new Public Procurement Act was introduced in 2004 in order to bring Hungarian practices in line with EU standards, however, it has been amended several times every year, adding to regulatory confusion and lack of transparency. Finally, although Hungary's Criminal Code forbids bribery in the public and private sectors, and imposes criminal sanctions on companies for acts of corruption committed by individuals working on their behalf, there is no distinction between bribes and facilitation payments, and gifts and hospitality may be considered illegal depending on the intent and benefit obtained. The practice of bribery is thus widespread and enforcement gaps are common, especially in relation to foreign bribery cases.

Corruption in the public and private sectors furthermore appears to be growing more flagrant. According to EU figures, 70% of population considers government's efforts to fight corruption as ineffective, and political parties, private businesses, and public officials are viewed as the most corrupt entities. In 2014, the U.S. government banned six Hungarians implicated in corruption charges from entering the country. While the U.S. has not announced the specific names on the list, the head of Hungary's National Tax and Customs Administration (NTCA), Ildikó Vida, admitted to be among the group. The NCTA has been accused of turning a blind eye to VAT fraud committed by government officials and bribing American companies with tax breaks in return for funding policy papers that favor Prime Minister Orbán's administration. The government has not shown much determination in pursuing these charges; while Ms. Vida resigned from her post, she has not been the subject of an investigation. [Indeed, backed by the Orbán government, she attempted to bring a libel suit against an officer at the US Embassy in Hungary.] In the spring of 2015, massive demonstrations against government corruption broke out across the state as the European Commission suspended payments to Hungary over suspected corruption and irregularities in the awarding of tenders – Transparency International warned that, on average, Hungarian companies that won contracts for EU projects overpriced their products by an average of 25%.

Fiscal support: investment and access to credit

The availability of credit and capital form the foundation of modern enterprise development. In the early 1990s, the Czech Republic, Slovakia and Hungary all faced the challenge of dismantling a central monobank system through a series of difficult measures: the stabilization and capitalization of the banks; privatization of the banking sector; introduction of banking regulations; and opening of access to credit for private firms and individuals. The three states all implemented these strategies, albeit with varying priorities and economic circumstances that led to differing outcomes. The Czech voucher privatization scheme created deep weaknesses in the banking sector, leading to a financial recession in 1997. However, as the government had expressed commitment to a rapid transfer to a private-sector managed economy, it managed to quickly and effectively respond to the crisis through policies that both reformed the banking sector, and maintained focus on the continued development of private, domestic firms and SMEs. Both the Czech Republic and Slovakia implemented sound banking practices centered on prudent risk management and assessment of loans. The Hungarian banks, however, under foreign ownership and focused on large, foreign-owned enterprises, essentially excluded domestic companies and SME. Instead, record profits were achieved through distribution of loans held in foreign currencies to households and individuals. The sector was hence fully unprepared for the global financial crisis of 2008, and has not posted meaningful and lasting recovery.

The overall rate of investment fell across Eastern and Southern Europe following the collapse of central-planning regimes. In the Czech Republic, gross domestic investment as a share of the GDP fell from 27% in 1989 to 17% in 1993 and rose to 20% following price liberalization 1994, a level comparable to that of developed economies. State sector investment understandably suffered the sharpest drop. As capital transfers from the state fell, net borrowing from financial institutions rose sharply and perhaps excessively relative to the level of economic development.

In 1993 and 1994, enterprises obtained financing that amounted to 95% and 62.3% of total investment, respectively (Table 4.5: Czech Banking Sector). Early investment was particularly pronounced in manufacturing, transport, and services such as housing, education and health. The ratio of domestic credit provided by banks reached 80% in 1996, a rate similar to the average of other countries with comparable GDPs.

However, in the early 1990s, the Czech government implemented a “German” banking model, permitting a few dominant commercial banks to hold large stakes in industrial conglomerates. These banks managed IPFs that coalesced individual voucher shares into controlling stakes of conglomerates, and were thus tasked with monitoring performance and restructuring of firms. Furthermore, the banks retained lending power towards these firms, and approved large loans in an attempt to consolidate large manufacturing enterprises able to effectively compete in the European marketplace (Horowitz, 2000). Accordingly, while lending to enterprises reached 67.9% of the GDP in 1994, and fell to 56% in 1997, only 10% of that total was extended to new companies (Table 4.5: Czech Banking Sector). State-owned and largely unreformed banks continued lending to large, often semi-privatized, firms – traditionally their principal clients – without particular effort to improve access to capital for emerging private firms and SMEs.

Such cross-ownership of investment funds and banks, coupled with poor bankruptcy laws and procedures, effectively undermined the health and effectiveness of Czech banks due to an abundance of bad loans and the subsequent reluctance to pursue bad debts. The weak financial discipline in sector failed to impose safeguards against external shocks, and the 1997-1999 international financial crisis deeply reverberated within the Czech financial sector (Horowitz, 2000). Despite efforts to strengthen banks' balance sheets prior to the 1997 banking crisis, non-performing loans accounted for 35% of all bank loans between 1995 and 1996. Small banks moreover routinely suffered from undercapitalization, exhibited fraudulent management practices, and took imprudent risks: of 18 small banks, 15 were forced into a consolidation program in 1996, with nine of them radically altered (Barta, 2006). A significant number of unviable smaller banks failed between 1996 and 1997, damaging public confidence in the banking sector.

In response to these challenges, the Czech government undertook a series of reforms designated to address structural issues, curb relaxed bank lending, enhance transparency and investor protection, tighten the regulatory regime, and improve corporate governance and conditions for business activities through two packages of economic reforms in early 1997. The cornerstones of these reforms, the Investment Funds Act and Banking Act, attempted to clarify and restrict the relationship between the financial and the enterprise sectors. Banks were required to separate commercial and banking divisions to prevent equity positions from setting lending policies, and to design better and stronger loan provisions and procedures for managing and liquidating weak funds. Moreover, in 1998, the Czech Republic finally established a formal Securities and Exchange Commission, funded by the central government, with the aim of supervising, regulating and centralizing the financial markets, and promoting transparency of operations. The adoption of the SEC and an amendment to the commercial code that required the disclosure of significant minority stakes caused the stock market turnover to sharply rise. Legislation introduced in 2000 aligned local securities regulations with EU standards.

The Czech government likewise identified the privatization of state-owned banks, improvement of insolvency procedures, restructuring of financially distressed firms, and the elimination of an overabundance of small banks as critical to economic reform. Fiscal subsidies were essentially eliminated, and commercial banks were subsequently offered and sold to international investors. The Czech Consolidation Agency (CKA) was formed to sell off bad assets to private investors. Although the clean-up of the bank portfolios resulted in a decline in total assets to GDP (116% at the end of 2001, as compared to 132% at the end of 1997), it strengthened the overall health of the sector. By the end of 2002, classified credits had dropped, while net profits, deposits, and capital adequacy ratio rose (Table 4.5: Czech Banking Sector).

The volume of outstanding credits provided to the private sector by banks decreased by 2001, as non- performing assets were removed from balance sheets, and the initial excessive credit was brought closer to the equilibrium. Domestic credit provided by banks did not increase to more than 50% of the GDP until 2007, and has expanded moderately since then (Table 4.5: Czech Banking Sector). Cross-border lending by foreign banks significantly contributed to the capital formation, with loans principally directed to the non-banking private sector. As the economy recovered from the 1997 financial crisis, Czech banks went through a period of significant financial deepening, and increased growth in credit to the private sector. Both public credit bureau and registry coverage increased dramatically in the ensuing decade and a half.

The Czech Republic has continued to make noteworthy progress in certain areas that had previously been particularly detrimental to private enterprise. Credit has become easier to obtain with advancements in the scope, coverage and accessibility of credit information and credit bureau coverage over the past decade. In 2014, the Czech Republic further improved access to credit by adopting a new regulatory regime that strengthened the legal rights of lenders and borrowers under collateral and bankruptcy laws, and allowed out-of-court enforcement of collateral, as has been recognized by the World Bank. Confidence in private sector performance has been boosted by the relative ease of investment capital flow: the Index of Economic Freedom has graded the Czech Republic as free in terms of financial freedom and mostly free in terms of investment since the nation's independence, raising its latter rating to free in 2014.

Despite improving business conditions in Slovakia, the inflow of foreign direct investment in the early years of the transition failed to match levels in neighboring countries, partly due to extensive state interference and corruption. Gross domestic investment was thus forced to shoulder 35% of the GDP in 1998; with the introduction of measures to spur FDI flows, the domestic share of credit fell to 21% in 2014, virtually all of it from non-government sources (Table 4.10: Slovakia Banking Sector). The decline in investment was offset by a rise in private financing. Domestic credit to the private sector was under 40% of the GDP prior to 1997, but rose to almost 55% of the GDP by 1998. In the six-year period that followed, as FDI grew, domestic credit and domestic credit provided by banks greatly contracted, though it has since been on the rise (Table 4.10: Slovakia Banking Sector). In the late 1990s, the recipients of banking loans were diversified: the proportion of total loans to the manufacturing sector fell from 29.5% in 1997 to 19.2% by 2001, with the share of loans to individuals rising from 5.2% to 15.3% in the same period.

As Slovakia slowed the privatization process in the mid-1990s, approximately 40% of bank equity remained under the control of the state. Concomitantly, virtually no basic capital was required to found a small bank, and a number such institutions arose following Slovak independence. They were commonly plagued by inadequate capital, lack of long-term financial resources and savings, and a high share of bad loans that likewise permeated state banks, which were burdened by insolvency of many privatized companies, secondary inter-company indebtedness, and a government policy of debt-forgiveness for firms. As privatization efforts restarted in the second half of the decade, Slovak banks underwent significant reforms in preparation for their transfer to the private sector. Four insolvent, private banks were liquidated, and by 2000, the sector was more than 90% foreign owned. The government injected basic capital into the banks, and shifted a large share of bad loans to a state-controlled consolidation bank. By 2001, the banks were highly liquid, thanks to the Central Bank's sterilized purchases of capital inflows, government responsiveness in bailing out struggling banks, and conservative bank management following restructuring and recapitalization in the late 1990s. The ratio of liquid assets to short term liabilities and total assets rose substantially between 1997 and 2001. Following Slovakia's entry into the EU, strong economic growth opened a greater volume of client loans in all sectors. In 2002, the government introduced new banking regulation that further strengthened risk management, corporate governance, enforcement, and role of supervisors, who were granted explicit authority to demand corrective action plans to strengthen banks' fiscal positions. As supervisors were predominantly foreign entities, bilateral cooperation was established to grant Slovak officials better insight into potential challenges and appropriate responses in the banking sector.

The dominance of foreign ownership in Slovak banks opened the possibility of extreme vulnerability to external shocks. In 2012, domestic-owned banks held only €153.9 million of a total equity of over €2.7 billion in commercial banks in Slovakia. However, the 2007-2008 global financial crisis did not create high turbulence in the Slovak banking sector, as compared to other developed economies. Slovakia had adopted the euro prior to the crisis, and while the currency change was associated with costs from exchanges and supporting operations, bank loans of foreign were held in a domestic currency, a circumstance vastly different from that in Hungary. The Slovak bank industry was mainly linked to domestic economic activities, and cautious lending practices had insulated the sector from high-risk instruments deployed in other financial markets. As exports declined between 2009 and 2011, conversely, and the domestic economy entered a recession, banks increased their funds, and adopted highly conservative financing, leading to a decline in investment opportunities, particularly in corporate lending, some of which was offset by an increase in FDI. The value of loans to the private sector and credit bureau coverage have increased steadily since 2004, although the share of nonperforming loans has continued to fall (Table 4.10: Slovakia Banking Sector). In the last five years, markets have calmed, and some growth has been restored, bolstering the banking sector, which continues to display an ample liquidity cushion, and bank stability ratings by the World Economic Forum have been high across transparency, financial stability, and access to loans.

Much like the Slovakia, Hungary quickly adopted a program of direct-sale bank privatization to foreign owners as part of its transition agenda – indeed, it was the first state in the CEE to initiate bank reforms. New legislation on banking measures was adopted in 1991, and between 1993 and 1994, the government enacted several directives to improve bank operations in preparation for their privatization. State-owned banks were recapitalized, and the share of bad loans was drastically reduced from over 25% in 1993 to under 3% in 1999, so outperforming all regional competitors. Portfolios of (future) commercial banks were cleaned, and nonperforming loans transferred to three newly founded state banks By 1999, the asset share of state owned banks fell to 9.1% from over 75% in 1991, while the asset share under foreign ownership rose to

80%. By the end of the 1999s, the banking sector in Hungary was generally sound due to a comprehensive consolidation effort. Foreign bank ownership increased to reach a peak of 87-88% between 2006 and 2008.

However, some issues specific to Hungary persisted. Direct sales of companies led to a comparatively very small stock market portfolio; market capitalization remained below 15% of the GDP until 1996, before climbing to just over 35% in 1999. Notwithstanding this progress, market capitalization did not reach the levels of other regional economies at the time of Hungary's entry into the EU. Moreover, despite health of banks, the ratio of domestic credit to the private sector shrunk between 1993 and 1999 (Table 4;15: Hungary Banking Sector). Domestic credit to enterprises initially fell, and stabilized around 20% after 1997. Financial depth, too, fell and remained low at 70% of the GDP in 1999 – far below the ratios observed in developed economies – as a consequence of low levels of credit to households and corporations (Table 4;15: Hungary Banking Sector). SMEs benefited even less from bank privatization. Loan risk assessments from SMEs remained more difficult and stringent, and banks gave preferential treatment to large corporations; in 1998, SMEs accounted for only 4% of total bank credit to enterprises. Undoubtedly, many businesses in Hungary chose not to seek financing through banks, especially considering the high levels of foreign ownership and FDI. Yet the low proportion of credit granted to such businesses when compared to regional counterparts suggests that SMEs were actively shut out of the credit sector due to bank practices. Though Hungary managed to radically cut nonperforming loans, the remarkable success of the initiative suggests extremely conservative and risk-averse corporate lending criteria for private firms.

By contrast, household debt exploded between 2000 and 2007. By its accession into the EU, Hungary was a regional leader in indebtedness of the state, commercial banks, households and municipalities. Banks posted record profits between 1998 and 2008, driven chiefly by high interest margins and high interest income. Yet as much of lending to households was in the forms of general purpose loans, this was not translated into accompanying economic growth. Bank deposits increased by 50% from 2004 to 2008, while the household loan portfolio tripled. Consequently, the foreign-owned banks' loan/deposit ratio exceeded 100% in 2000, peaking at 180% by the end of 2008. Seeking to match lending capacities, local banks similarly increased their foreign funding and loan/deposit ratio, which reached 130% by 2008. Liquid assets accordingly steadily declined, from 50% to 5% of total assets between 2001 and 2007 in local banks. Foreign currency loans to the non-banking sector exceeded 65% in 2011, with more than 70% of such debt held by private households. Despite IMF warnings about high levels of household debt held in foreign currency, the government did not match steps taken in other CEE states towards placing restrictions on such loans.

Hungarian banks have suffered crippling losses since the 2008 crisis. Private credit flows dropped to 4.2% of the GDP in 2010, and -6.1% in 2012, as the share of nonperforming loans rose to 14%. Bank profitability has been depressed by a succession of stringent government measures, most notably the enforcement of a sectoral tax on banks in 2010, the last year banks in Hungary posted a profit, and a one-off transaction tax in 2013. The following year, the state introduced a foreign currency debt relief program that permitted lump-sum repayments of mortgage loans held in foreign currencies at discounted exchange rates, generating massive one-off losses for banks. In 2012, a similar scheme allowed borrowers to repay loans at fixed exchange rates In 2011 an initial foreign-currency debt-relief program allowed lump-sum repayments of foreign-currency mortgage loans at a discount exchange rate, creating sizeable one-off losses for banks. Finally, between 2014 and 2015, the government implemented a compensation of borrowers by banks in penalty for "unfair" exchange and interest rates, and forced the conversion of outstanding household and unsecured loan debt held in foreign currency and equal to 15% of GDP to domestic currency, so eliminating the foreign exchange risk exposure of households. The reduction in private debt, coupled with a strengthening labor market contributed to rising lending to households. The 2016/2017 banking outlook appears somewhat more promising, as one-off measures are expected to cease, and the sectoral bank tax is to be somewhat reduced. Yet banks remain burdened by bad loans: in 2015, the stock of total non-performing loans stood at over 9%, including 24% for corporate loans and 22% for retail loans (Table 4;15: Hungary Banking Sector).

More troublingly, in 2013, Orbán's government began the process of bank re-nationalization, acquiring close to 20% of bank assets by 2015. The state announced the measures would boost domestic ownership in the banking industry and spur lending to SMEs and households. Such steps have more recently been halted, and the government has agreed to a resale of some assets, in order to regain better investment grades that plummeted following the nationalization. Access to credit did indeed somewhat improve between 2015 and 2016, and Hungary was ranked 29th by the World Bank Ease of doing business in terms of access to credit, though much of this advance has targeted households, not enterprises. Corporate lending has not yet begun to grow, and central bank strategies to promote lending to SMEs have at present managed only to stabilize the outstanding stock of loans. Banks remain in a deeply precarious position, and doubts over its future health and stability – as well as uncertainty over possible government interventions – continue to suppress progress in the sector.

Support for SMEs

In 2008, the European Union adopted a Communication on the Small Business Act (SBA). Recognizing “the central role of the SMEs in the EU economy,” the SBA validated the ‘think small’ tenet promulgated by empirical research that emphasized the potential for SMEs to generate and sustain economic growth within developed and developing economies. The EU encouraged member states to strengthen and promote SMEs by lessen administrative requirements; improving access to finance and new markets; protecting property rights and competitive practices; and advancing investment in human capital and research and development. The Czech Republic, Slovakia and Hungary, which had successfully built SME sectors throughout the 1990s and into the new millennium all followed through on many of these proposals. However, the structural development of their respective SME sectors, driven partially by their ability to institute a budding entrepreneurial culture through liberalization and privatization in the early stages of the transition, has accounted for much of the differences between the varying degrees of SME success.

The Czech Republic has a legacy of a vibrant small and medium enterprise sector; in the 1930s, two thirds of the Czechoslovakian labor force was employed through SMEs. Although much of this heritage had been eradicated during the communist regime, SMEs experienced a fast resurgence following the introduction of a market economy. By 1994, such firms accounted for 37% of employment, and were granted access to longer maturity loans. Financing for training, credit subsidies, consultancy and applied research were authorized through a 1992 National Council Act, and benefits were extended in 1994 with price-support guarantees, contribution to interest payments through bank credits, and interest free loans for some technological projects. In order to encourage new enterprises, in 1999 the government approved a small and medium-sized enterprises policy, defining a reduction of legal and administrative burdens; improved access to capital; export promotion and information and training as necessary elements for support of the sector. The government also increased the funding of SME Development Support programs to €52.3 million in 1999, double that allocated in 1998, and vowed to gradually increase funding levels by € 27.5 million until 2002 through guarantee scheme and soft loans.

In 2001, the number of newly created companies in the SME sector totaled approximately 9,000, while the total number of SMEs reached some 770,000. That same year, SMEs produced 42% of GDP and employed about 60% of the workforce in the non-financial industry. By 2009, that number had increased to 70% of the workforce in the non-finance sector, and more than 59.43% of Czech human resources in the national economy. By 2012, the World Bank reported that almost 100% of active enterprises in Czech Republic were represented by SMEs. In aggregate, they generated 53.81% of added value to the GDP.

Financing conditions for domestic start-ups nevertheless remained difficult due to tough business plan assessments, strict credit rules, cautious lending practices that arose as a consequence of the 1997 banking crisis, and persistently weak bankruptcy laws. The Czech Republic cut bureaucratic restrictions by 8% in 2007 and 2008, with an aim of reaching a 20% reduction by 2010. Micro-enterprises have lower accounting requirements than standard companies: they are permitted to deduct 50% of their income as expenses, and are no longer obliged to do not have to provide receipts to justify expenses. The SME access-to-finance index for the Czech Republic has shown a continuous, albeit small, improvement in credit availability between 2007 and 2012. However, this masks two opposite developments: access to debt financing provided by banks is comparatively easy and affordable, and has increased substantially between 2007 and 2012; concurrently, access to equity financing appears to have worsened. As a consequence, the European Commission's SME access-to-finance index has ranked the Czech Republic as the EU Member State with the lowest accessibility of equity financing, and with a general lack of early-stage financing programmed for SMEs through the equity channel. The Czech government has announced it will catalyze investment in SMEs through a 2014 Act on investment companies and funds that is designed to encourage private financing of SMEs at all stages of their development. The Act was accompanied by a project to launch a seed and venture capital fund supported by EU funds, which is currently stalled and intended for revitalization in upcoming years.

Slovakia boasts a stable and dynamic SME sector, which in 2013 provided 59.5% of employment and 55.6% of added value to the economy. The share of SMEs in all the registered enterprises in Slovakia has been stable since 1993; however, since 1998, there has been a noticeable decline of SMEs in foreign trade. Slovakia's principle exports revolve around the automotive industry, which is chiefly supported by large, foreign-owned firms. Public support for the SME sector is provided by the National Agency for Development of Small and Medium Enterprises, which supports their initiation, development and growth, and actively monitors the development and state of SME entrepreneurship. It accordingly prepares and implements a wide range of financial support programs, the most significant and prominent of which have revolved around counseling and training. Support program activities are divided into four main areas: stimulation of the SME sector growth; improvement of the competitiveness of SMEs; globalization and penetration into new markets; and facilitation of access of SMEs to capital. Between 2007 and 2012, the Slovak government published and implemented a plan to cut 25% of bureaucratic red tape for SMEs, including bookless accounting for expenses

The EU's 2013 SME Access to Finance survey reported that Slovakian firm managers believed that banks' willingness to issue loans to SMEs had vastly improved since 2011. Only 2% of SMEs felt access to credit to present a serious problem. Conversely, late payments present a lingering challenge, with 65% of SMEs admitting to liquidity problems that have lead to postponement of payments to suppliers, selling of assets, and increased bank loans. The government has rejected a direct intervention in disputes between suppliers and consumers, and has indicated late payments could be addressed by borrowing, increased access to credit, and simplified tax and VAT regimes. Nevertheless, equity finance for SMEs remains quite limited, and businesses have few capital sources outside of traditional bank loans, leading firm managers to conclude that access to finance was an "extremely pressing" problem. The government has restricted direct support to technology transfers and energy-efficient innovations. In response to ongoing financing difficulties, however, in 2012, the Slovak Guarantee and Development Fund implemented the first loss guarantee agenda through a contract with commercial banks to provide rapid bank guarantees. In 2014, the Slovak government launched a Venture Capital and Seed Funding program through the EU's JEREMIE initiative. New state aid rules have enabled Slovak authorities to establish clusters of SMEs to jointly access European funds.

The Hungarian SME sector at first glance appears to be similar to that of the Czech Republic and Slovakia. Small, private firms were tolerated toward the end of the communist period, and the number of SMEs rose rapidly in the decade following the transition to presently encompass 70% of the workforce, and 53.6% of the value added to the GDP. Employment in SMEs grew even as general unemployment rose between 2002 and 2008, though most of that growth can be attributed to self-employment. In fact, in contrast to the Czech Republic and Slovakia, and, indeed, the EU average, Hungary’s SME sector is dominated by micro firms that employ fewer than 10 persons; 95.1% of all active enterprises can be classified as micro firms, and 76% of firms have only one or two employees. This creates special pressures on the SME sector: performance, equity and assets of Hungarian microenterprises lag far behind the EU average. As in Slovakia, micro SMEs have been trapped in a pattern of circular debt, as more than one third of clients are delinquent in payments, creating problems of illiquidity and backlogs of debt.

Much of the stagnation within the SME sector in Hungary can be attributed to weak access to financing and credit. The financial crisis has had a pronounced impact on SME lending, which declined by almost 30% between 2008 and 2014. Credit conditions tightened and have remained restrictive, particularly toward SMEs and businesses seeking long-term finance: the interest rate spread between loans to SMEs and large firms stood at 2.7% in 2014, up from 1% in 2008. This risk-averse behavior and deleveraging are tied to a general inability of SMEs to meet loan obligations: by 2014, 20.7% of the outstanding SME loan portfolio was non-performing, up from 5.4% in 2009, well above the share of non-performing loans in overall corporate lending. Only 20-22% of Hungarian SMEs are deemed to be credit worthy, in comparison to the European average of 70-85%, and only 22% have a bank account. Considering the difficulty in obtaining sufficient credit, for much of the past decade, the net number of SMEs in Hungary predictably did not increase, a unique case within the EU. Only some 44% of the population views SMEs and entrepreneurship to be a viable source of personal and economic growth, as compared to 58% across Europe, and self-employment, though prevalent, is often regarded as a last resort – only a quarter of Hungarians express interest in self-employment.

In 2013, the Hungarian Central Bank established the Funding for Growth Scheme (FGS) to provide interest-free refinancing loans to financial institutions willing to extend credit to SMEs at a capped interest rate. Within two years, over 31,000 firms obtained loans equaling 5.8% of the GDP through the FGS. However, the program is currently being phased out in favor of a 3 year interest rate swap on lending activities for banks with sufficient stocks of SME credits. Venture capital investments to innovative, fast-growing start-ups have attempted to fill the gap in funding, and have risen by over 200% between 2009 and 2014. However, the venture capital market is not domestically driven, but is rather largely dependent on funding from the from the European Commission and the “JEREMIE” program.

The Hungarian government has recently been very critical of the failure of foreign owned commercial banks to provide credit to small Hungarian firms, and some officials have advocated protectionist measures or the establishment of a state-owned bank to direct lending to SMEs. Direct government support to the sector at the moment remains low, at approximately 4% of the GDP, well below the EU average of 11%. The tax regime and regulatory burdens remain cumbersome and costly; over 30% of firms hold tax rates to be the biggest obstacle to further growth, according to the World Bank. SMEs continue to bear a disproportionate burden of public regulations and obligations.

The focus on recent difficulties of the SME sector to gain access to adequate financing has overshadowed a discussion on why Hungary was so susceptible to the formation of micro firms. No empirical study has produced clear findings in this matter, and the subject has not generated much discussion. Nevertheless, an overview of Hungarian development in the 1990s suggests two possible, mutually-reinforcing explanations. Firstly, under political directives, commercial banks began to issue loans to SMEs in the early 1990s without satisfactory risk assessment. As loans began to fail, banks withdrew from the sector, leaving SMEs financially underserved or completely excluded from the financial markets, and hence unable to invest in new products, employees, and development. Secondly, Hungarian liberalization and privatization schemes advocated the primacy and importance of large enterprises and foreign ownership over small-scale and inclusionary participation in the new market economy. Consequently, national economic agendas were set without much regard to the expansion of a vibrant small and medium business sector. Additionally, Hungary failed to create enthusiasm for an entrepreneurial culture. Public interests remained tied to large corporations; entrepreneurship was largely not viewed as a viable means of economic progress, and self-employment was treated as a last resort.

Summary

The evidence displayed in the development paths of the Czech Republic, Slovakia, and Hungary affirms the role of entrepreneurship in driving economic growth. Moreover, it demonstrates how critical government policies could determine, promote, or hinder the emergence of a successful entrepreneurial sector and culture. All three states in question must still face significant challenge, particularly in the areas of administrative processes and regulations. In many instances, legal regulations do not offer adequate protections and support for private sector activity; in others, existing principles are not properly applied and enforced. Still, the progress achieved by the private sector in the Czech Republic and Slovakia despite these issues suggests that institutional considerations cannot be judged without accounting for the market environment and practices.

The extensive liberalization and privatization schemes in these states generated a commitment to market reform and the establishment of entrepreneurship. This promise to the promotion of a business sector took various forms, from encouraging the formation of SMEs and domestic firms, to requiring bank practices to assist in supporting a diverse private sector. Moreover, entrepreneurial culture has been self-propagating. As more firms are founded within the economy, and begin to contribute increasing value to the GDP, they increase both the reputation and desirability of entrepreneurial activity, and secure continued government support. It is precisely this factor that underscores an important element of the mass privatization program in Czechoslovakia, and the Czech Republic: although it indisputably caused some economic problems, it also sparked the creation of an entrepreneurial culture. Chapters 5 and 6 demonstrate that this process took place in a constructive economic and fiscal setting marked by low inflation, debt and deficit levels, and free of excessive and burdensome support for failing industries and social welfare programs. Yet there, too, the transfer of economic stewardship to the private sector eased and enabled the establishment of such agendas. Hungary, however, has struggled to translate the overall success of its early economic development, propelled by large firms and foreign investment, into a lasting entrepreneurial culture.

CHAPTER 8: CONCLUSION

In June 1996, The Economist published an article (Sachs, 1996) based on the results of a global study that demonstrated the importance of sound economic policies in determining growth: had African countries mimicked the strategies of eight fast-growing economies over the last few decades, the study showed, the region would have grown 4.6% per annum faster than its historical growth rate – indeed, more rapidly than a comparative set of fast-growing economies. Yet a mere year later, The Economist appeared to largely contradict these findings through another global empirical study, coincidentally by the same author (Sachs, 1997), that found "for much of the world, bad climates, poor soils and physical isolation are likely to hinder growth whatever happens to policy." While the latter study did not claim better policies would have failed to produce faster or more sustained economic development, it highlighted the importance, and perhaps predominance, of physical inputs in driving outcomes. The study posited that even if states in Africa had implemented more sound economic agendas, they would have grown on average 2.3% slower the countries of South and Southeast Asia.

These two articles, with their markedly different conclusions, provide an illustration of the difficulty in theorizing about and testing the conditions and variables that generate and sustain economic growth. Overall, attempts to determine the causes of long-term economic growth by empirically testing a wide range of possible determinants have produced results that are vague and even contradictory. Moreover, when looking at states that posses basic physical and human capital resources necessary to achieve growth, research has been largely unable to explain why some states secure lasting growth while others fail. This uncertainty has particularly problematic implications for institutions and policy makers seeking to design and implement – and, in frequent cases, externally impose – domestic development strategies. Empirical evidence seems to provide little guidance for the universal efficacy of any individual policy prescription. However, there is a crucial and important mismatch between the actual economic world and the model of the economic world that underpins much of the current search for causally significant variables. Evidence indicates that country growth experiences have been heterogeneous, and empirical research often fails to grasp the enormous complexities of causal relationships and processes across states and economies. In order to advance our understanding of the multifaceted and varied practices that drive or hinder economic growth, it may therefore be necessary to deeply examine the inner mechanisms of a particular and similar set of real economies rather than trying to assimilate diverse states into abstract universal models. Such qualitative accounts of economic development may not necessarily lead to conclusive causal narratives, but they can lend insight into what factors may be critical under certain conditions, what factors can allow for or prevent the establishment and advancement of essential variables, and what types of policies are best able to create the environments that promote economic growth.

This thesis thus explored the processes that allow for economic growth in second tier states. In examining the development of the Czech Republic, Slovakia and Hungary, with a particular focus on post-transition policies, this work proposes that certain variables and processes have been critical in ensuring long-term growth, and explains the conditions that have enabled the establishment and promotion of economically sound policies. The states of Central Europe present an especially interesting comparative case study: similar geographic, cultural and physical characteristics, and a shared history of central economic planning under the communist regime led to similar economic environments at the start of the 1990s. Yet their economic development over the course of the past two and a half decades has varied sharply, a divergence that can be ascribed to the policies pursued by their respective governments. Perhaps most remarkably, the period following the 2008 economic crisis has brought into question long accepted theories about development within the region. Hungary, once widely lauded as a leading example of a successful post-transition strategy, has been unable to catalyze an economic recovery, and has pursued an economic agenda that has undermined not only its economic forecasts, but its status as a free-market democracy. By contrast, the Czech Republic and Slovakia, which had at times been criticized for economic underperformance, have proven resilient to both internal and external economic shocks, and are poised to continue to enjoy stable growth for the projected future.

Yet the policies that have created this dramatic variance in economic prospects of the region are not the consequence of the financial crisis; indeed, the crisis merely exposed existing strengths and weakness of the region's respective economies – strengths and weaknesses that have been the product of strategies pursued since the states' independence. As this thesis shows, two critical factors stemming from the early transition period have been decisive in setting the development agendas of the states almost three decades after their independence: the pace and extent of liberalization programs; and the pace and type of privatization schemes. The scope and success of these programs influenced the ability of states to create private sector environments conducive to entrepreneurial activity, and to set fiscal measures necessary for the support of a vibrant and stable economy. The Czech Republic, and to a somewhat lesser extent Slovakia, which more readily and fully transferred management and stewardship of the economy to the private sector by liberalizing markets, eliminating support for unviable state industries and privatizing business activities, and encouraged broad public participation in the new private market system, have maintained better conditions for continued investment and entrepreneurial advancement, and have found it easier to introduce and sustain disciplined fiscal and budgetary measures. Hungary, which from the early years of the transition sought to protect specific industries, and failed to introduce a liberalization and privatization agenda that invigorated widespread public support for new private sector activity, was unable to build a sound domestic economic environment.

The key task of liberalization reform is to create conditions that will generate incentives for new market entry and shift the emphasis of enterprises from rent extraction to entrepreneurship and productive investment. The extent to which the states examined in this thesis were able to implement stable and continued economic growth has depended largely on their ability to shed former, paternalistic economic systems, and to introduce policies designed to create and foster a competitive economic and investment climate. In Czechoslovakia, where new economic and political actors began the transition process driven by a desire to institute economic liberalization, the state quickly adopted practices that liberalized trade, competition and prices across virtually all industries. This process supported new, competitive and efficient businesses while eliminating cumbersome and unviable firms. Furthermore, although liberalization necessarily depressed the economy immediately following the transition, its rapid deployment permitted the government to vest itself of industries and budgetary expenses that had the potential to permanently deteriorate economic growth. In Hungary, however, leaders of the transition did not unify behind a comprehensive liberalization agenda. As a result, the state introduced partial liberalization reforms that created the expectation that the government would continue to mitigate the social or public negative effects of the transition to a free market economy. Following a recession in the early 1990s, and an electoral rebuke of some early reform policies, successive governments proved unwilling to assume the political costs of liberalization measures that became progressively more difficult to realize.

Hungary exacerbated this issue with a privatization program that transferred control of state owned enterprises principally to foreign owners through direct sales. Throughout the 1990s, this approach was generally applauded for restructuring ineffective enterprises through foreign expertise and management. Recent evidence has revealed two major shortcomings of this privatization scheme. Firstly, Hungarian governments were able to use one-off fiscal infusions from the sale of state assets to finance expensive and unsustainable social programs. As privatization of state industries drew to a close, Hungary began to suffer budget deficits that ultimately destabilized its economy and prevented economic recovery following the 2008 crisis. Secondly, privatization efforts in Hungary did not bind domestic agents to the new private market system. Accordingly, Hungary suffers from a low number of domestic private enterprises, and continues to struggle from a staggering level of informal market activity. In the Czech Republic, where a mass privatization plan introduced broad public buy-in into the market, the entrepreneurial environment has been far more encouraging of small and medium enterprises and official sector participation. Finally, as a result of relatively low levels of public entrepreneurial participation in the formal market, support in Hungary for measures that benefit the market at some social cost have been wildly unpopular. Slovakia, which attempted both privatization types, has thereby both experienced the benefits of broad support for private enterprise, and struggled to temper expectations for high levels of state support for social and welfare programs.

However, it seems highly improbable that new sectors can thrive if a state is simultaneously seeking to protect state enterprises and privatized firms that continue to behave as and receive support of public enterprises. Entrepreneurs have no incentive to bring in new management, develop new products, or seek new markets needed for growth-oriented restructuring if explicit subsidies or implicit support extended through banks and public utilities and protection from competitive pressures keep them afloat. The inheritance of the command economy included stifling administrative barriers to entry, overregulated labor markets, and tremendous discretion for bureaucrats. All states in Central Europe have found it difficult to reduce excessively high marginal tax rates; simplify regulatory procedures; establish secure property rights; provide basic infrastructure and institutional security; and encourage incentives for wealth creation rather than rent seeking and asset stripping by new enterprises. Weak institutions of public and corporate governance coupled with ineffective legal and judicial mechanisms across the region have routinely led to asset stripping and violations of shareholder rights. Still, the Czech Republic enjoys extremely high, and Slovakia moderate rates of business confidence in the private market. Where the state has provided support for private enterprise activity, it has been in the form of human capital development and investment in key sectors. In sharp contrast, Hungary displays the lowest business confidence rating in the region, which is further evidenced by the reluctance of businesses to shift from the informal economy.

Finally, this thesis shows that economic development in Central Europe has depended on introducing hard budget constraints, especially in limiting inflation and government spending; providing exit mechanisms for failing or underperforming industries or companies; and transferring social protections from enterprises to local and federal government. The Czech

Republic has been particularly successful in implementing a disciplined fiscal and budgetary policy that allowed it to meet and withstand external shocks that arose in 2008 and 2009. Yet at the start of the transition, Slovakia and Hungary likewise expressed a commitment to a hard fiscal stand that the former has at times moved away from, and the latter has been fully unable to maintain. Without complete and broad privatization programs that harnessed support for private markets in the face of social challenges, both states have adopted high welfare programs that have hampered economic growth. Without a comprehensive liberalization program, Hungary has continued to sustain inefficient firms. Continued resource transfers from nonviable enterprises have required the Hungarian government to loosen its fiscal stance, raise taxes elsewhere in the economy, and engage in off-budget activities, a trifecta of flawed options. A looser fiscal stance has weakened the credibility of the government's stabilization program and, by increasing market perception of risk, raised domestic interest rates, thus crowding out the new private sector. Intensifying taxation of the potentially more efficient private sector has formed a vicious cycle that pushes enterprises into the informal sector, thus lowering tax revenue and further increasing tax rates.

The basic implication behind the findings of this thesis is that upfront policies at the start of transitions matter. Hard budget constrains and support for private entrepreneurial activity are necessary for states to move from the second tier of development to the status of fully developed, stable economies. Yet they are unable to implement these measures without liberalized and privatized economies that ensure broad public participation in the market. The policy proposition for states in transition therefore appears to affirm shock-therapy advocacy of the early 1990s, provided that rapid liberalization and privatization efforts ensure and encourage public participation in the new market system, and are guided by a comprehensive reform agenda realized through a widely supported mandate. The importance of leadership at the start of the transition may thus be the critical element in determining a state's long term economic future. Initial conditions and political institutions affect the likelihood that some countries will follow particular reform paths. However, two and a half decades of transition show the indispensable role of political leadership in shaping reform. A thorough political economy analysis of winners and losers from reform can set the parameters for understanding the likely pressure points in any system and provide guidance for crafting feasible reform strategies. But it cannot predict the quality or strength of the leadership of the reform process that will motivate the pace and direction of reforms.

The propositions developed by this thesis open up several potential avenues for future research. One question that stems from this conclusion is how second tier states that are not emerging from a transition can grow in the absence of an economic shock. Such states likely have entrenched political and economic agents and interests that will resist extensive reform agendas; public resistance to the elimination of subsidies, protections and welfare programs is likely to be high in the absence of an economic shock such as the collapse of communist regimes. Future research can attempt to explore the dynamics of growth in these states. Are there successful examples of second tier states that drove liberalization and privatization to result in sustained growth, in the absence of economic shocks? Or is growth for these states driven by different processes? More generally, this thesis underscores the importance of context-specific, qualitative studies in helping address the gaps left open by large-scale econometric analyses of growth. By combining the knowledge developed through deep studies focused on understanding processes underlying growth with econometric analyses of the drivers of growth, the field can begin to develop robust, causal, and generalizable theories to benefit scholars and policy makers worldwide.

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