The Economic Impact of New Firms in Post-Socialist Countries: Bottom Up Transformation in Eastern Europe: A Review Article

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1. Introduction

Just as the title suggests, the message of this book edited by Horst Brezinski and Michael Fritsch is that bottom up transformation, that is the formation of new small firms, is the key to successful economic transformation in Eastern Europe. The book is a collection of papers which were presented at a conference in Freiberg, Germany, in September, 1993. The discussion ranges from "Who are the new entrepreneurs?" to "How can government policy encourage the formation of new firms?" This book sets itself apart from most books on transformation policy[1] in that it is aimed at micro policies rather than macroeconomic policies, such as those advocated by David Lipton and Jeffery Sachs (1992).

Some chapters do indeed touch upon macroeconomic issues, but most of them just give us the by now familiar run-down of what is needed for macro stability. One exception is the issue of using the exchange rate as a policy instrument. The Polish example has been used to emphasize the importance of not undervaluing a currency.[2] Keren uses the extreme example of East Germany to stress the importance of not overvaluing the currency. Most policy advice, however, is limited to mircoeconomic policies aimed at encouraging newly established firms.

Some of the underlying themes throughout the book are well-known in the literature, namely: the need for clarity in property rights, clear accounting procedures, fair and enforceable tax laws, and a developed banking sector. One newer issue that has recently received extensive attention in the popular press is the flourishing number of Mafia and black market transactions. Although it is agreed upon that rent-seeking activities and the general lawlessness of these groups wastes resources and does not promote economic efficiency, it is the opinion of many of the contributing authors that it is better to have these "bad" entrepreneurs than to have none at all. The "good" ones will come sooner or later. When we look at the development of many Western market economies, they are not without numerous important economic actors operating on the dark side of the law. This is not a perfect comparison, and some may argue that we should be able to avoid these "bad" entrepreneurs, but their contribution to the marketization process cannot be ignored. No cost-benefit analysis has been done to determine whether these dubious businesspeople do more harm than good, but the point is that they are not all bad, economically speaking.

Despite the rework of well-known topics, this book is more focused than previous books dealing with economic transformation in Eastern Europe. Themes like Big Bang vs. Gradualism and order of reforms are not addressed at any length. The needs of entrepreneurs and the trials and tribulations of new firms in the transforming economies are the central themes of all the chapters, the Ners chapter being the exception.[3] In addition, the mere fact that a few years have passed since reforms

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were introduced allow the country studies to offer some results of reforms, albeit preliminary, as well as the most current reports on conditions in the various countries. This currentness is the advantage the book has over previous publications on entrepreneurship in Eastern Europe.

The collection of papers in this book are quite diverse. Those chapters using a few published statistics and anecdotal evidence to support claims tend to be more general in nature, while the more analytical studies take freshly collected microdata and run it through a simple econometric model to reach a conclusion. It is these more analytical studies which offer some fresh results to the literature.

2. Transformation to markets

The book starts out with a chapter overviewing the role of and the conditions needed for entrepreneurship in any economy, market as well as transforming. These are widely agreed upon and offer nothing new to the area of discussion. An across-country study of the determinants of firm birth rates in developed countries concludes that population growth (approximating growth of demand) has the strongest positive effect on the formation of new firms, with the existence of other small firms (possibly signifying specialization) and urbanization/agglomeration yielding some positive effects, too, but this offers little assistance to market economies, let alone reforming economies, seeking to encourage entrepreneurship. Paul Reynold's main contribution here to the transformation literature is the study of adults in the state of Wisconsin (U.S.). He uses this study to point out that even in developed market economies, here the U.S., the overwhelming number of nascent entrepreneurs who are planning to start their own business never make it to the point of actually founding an enterprise. This suggests that Western market economies do NOT have all the answers for their transforming friends in the East when asked how to encourage the formation of new firms. Some sort of modification of western entrepreneurial encouragement is needed. This study helps identify a target group for government programs aiming to encourage nascent entrepreneurs in the U.S., but once again, this is not a perfect model to use for Eastern Europe. We must modify our target group in transforming economies, as we see later in Michael Thomas' profile of the east German entrepreneurial class.[4]

Michael Keren agrees in principle with the need to encourage nascent entrepreneurs. However, his contribution stresses the importance of phasing out the old government sector as quickly as possible. Like others, he advocates the creation of a new public sector which provides an operating environment as found in Western market economies. Keren creates a simple quasi-dynamic model of transtion to support his arguments. In his defense of quick privatization, he uses some common reasons such as the need to free up assets and increase government revenues. One less common argument he uses is that a reduction in the pace of liquidation of non-viable state enterprises would lower efforts of state enterprises to transform themselves into viable market participants. This is a way of making the threat of hard budget constraints credible. He also touches briefly on the strength of embedded networks, which is the topic of much new literature (Grabher, 1993), claiming that privatization is a necessary condition for transforming SOEs into efficient economic units by rendering the "hidden contracts" in these networks useless. A key to the model is the distinction between new firms in the tradables sector and those in non-tradables. He claims that it is the tradables sector that is the most dynamic and offers the most hope for growth in transforming economies. An interesting claim made is that the shady Mafia-entrepreneurs have their comparative advantage in the nontradables sector. Thus, government policy should focus on encouraging the less dubious entrepreneurs who would specialize in the tradables sector, which is not only better for growth, but will also stimulate government revenues which can be used for other programs.

Distinguishing between "good" and "bad" entrepreneurs is also stressed by Sergio Arzeni. Only the "good" entrepreneurs should be encouraged. New firms in manufacturing should be the focus of aid, since 80% of existing entrepreneurs are in the service sector at present. What Arzeni points out is that help from international organizations said to be for new firms completely ignores small firms, which is what most new firms are. Additionally, western consultants are not very effective. They only know how to operate in advanced markets and are therefore inappropriate for entrepreneurs' practical needs in post-socialist economies.

3. Country studies

The second half of the book is composed of a number of country studies. These studies are as diverse as the economic environments of the various eastern bloc countries. With few exeptions, these chapters offer merely a descriptive account of the present situation is the various post-socialist economies. For those not yet familiar with the transition literature, reading this section will familiarize the reader with the current issues involved with the introduction of markets. For those already up on transformation literature, this section offers the most recent reports on current conditions in the transforming economies. Unfortunately, many of the updates can be summed up by a two-word report: Nothing new. The growing number of new enterprises in the various countries is mentioned throughout this section of the book, conveying the idea that entrepreneurs in Eastern Europe are indeed on the move, albeit with problems which have not disappeared over the past 3 years. The more focused and analytical studies do offer some new perspectives, however. Statistics from surveys are used in almost all of the country studies to illustrate current conditions with respect to hindrances to small business owners, foreign investment, institutional dependence, origin of capital, etc. Policy recommendations are often similar to those offered by previous authors, but some studies supply a more focused target for policy.

The Bartlett and Hoggett chapter is the best example of the diverse environments across countries. Economic conditions in Bulgaria, Hungary, Slovenia, and Macedonia are studied, including standard indicators such as unemployment rates, GDP, share of new small firms, and sectoral distribution, but also infomation concerning past experience with western firms, intrepreneurialism, internal market systems, and political stability. These countries do have some things in common. There is a distinct lack of policies to promote small enterprise, given the scale of the problems faced. In addition, all four of the countries have difficulties implementing policies once these policies have been created. The "push" vs. the "pull" models of new firm entry are explained, but persisting barriers to entry are noted to dampen these incentives for entrepreneurs. The contribution this paper makes is basically a warning not to treat all transforming economies as if they were homogeneous when prescribing policy. The differences in initial conditions, including the degree of state control and the political and cultural climate, have influenced the way in which the small firm sector has begun to develop in these economies, so public policies to encourage entrepreneurs will need to be different in each country.

Also similar, but not identical, are the countries covered by Tschepurenko and Vilensky and Haav. Tschepurenko and Vilensky survey the newest policies put in place to aid small firms in Russia. The federal government finally realized that state support for small business must be a part of the government's overall anti-crisis economic policy, but its enactment of policies proceeds at a slow pace. Local and regional governments, on the other hand, have small firms high on their priority list, but the usefulness of their policies is yet to be determined. One puzzling aspect of this paper on Russia concerns the case study in the appendix: If local authorities claim to giving so much assistance to small firms, then why is it that a survey of small business owners showed "local civil servants" to be the number one force slowing down the reform process? Perhaps the cities used for the survey were not located in the regions giving assistance to small firms. Similar polls and surveys are used in Haav's chapter to give an overview of conditions for small businesses in Estonia. Lack of accessible capital seems to be the overriding problem there. The authors of both chapters conclude that small business owners are still having difficulties running their firms for various reasons, including lack of capital, inflation, low demand, and lack of a qualified labor force. The respective governments recognize this, but are having their own problems enacting effective policies to remedy the situation.

Even less optimistic are Gabor Hunya's chapter on Romania and Richard Ruzicka's chapter on the Czech Republic. According to the authors, private initiative there is still stuck in the grip of state authority. In addition to persistent macroeconomic problems, entrepreneurs are faced with more direct problems. In Romania there are vaguely formulated laws and contradictory regulations governing private business. Despite the uninterrupted increase in the number of private enterprises there, these small businesses are not flourishing due to incomplete liberalization and stabilization. Ruzicka's survey results from the Czech Republic show that regulations and financial problems (credit, taxes, etc.) are the top two problems facing small businesses there. Constantly changing regulations and newly introduced fees for new firms make accurate planning impossible and take a large part of entrepreneurs' borrowed capital, undermining many attempts to start up a new business.

The Houbenova-Delissivkova and Puchev chapter goes through a similar narrative with Bulgaria. Once again an underdeveloped banking sector leaves small businesses without adequate credit. High taxes also are cited as a hindrance. Although there was a boom in the number of new firms registered, according to official estimates, only 20% of those registered are actually engaged in some sort of economic activity. The rest have either ceased operation or never began operations due to "unfavorable economic conditions". The development of the private sector is seen as the key to the country's economic problems. The authors paint a pretty dismal picture, leaving the reader with the impression that Bulgaria is worse off than its neighbors due to the lack of *any* government policy encouraging the small private sector.

With this seemingly hopeless picture of Bulgaria's small business outlook, the reader continues on to Derek Jones' essay on Bulgaria. On the surface, Jones seems to be discussing a completely different country. However, upon closer examination, Jones comes to many of the same conclusions as Houbenova-Delissivkova and Puchev: In comparison to other post-socialist economies, small firms (including state-owned) play at least as large a role, but the private sector is underdeveloped and needs favorable government policies if it is to flourish. The difference between the two essays is that Jones starts one step earlier than Houbenova-Delissivkova and Puchev. Whereas they begin with the question, "How can we encourage private firms?", Jones begins with, "Which kind of enterprises should we encourage?"

Jones uses the available data to do a comparison of the performance of small and large firms and of firms with different forms of ownership. The results are presented, barely giving the reader chance to absorb the abundance of information. The most interesting result he offers is the Bulgarian answer to some recent debate about the importance of private ownership. After comparing similar sized cooperative, state-owned, and private firms, he finds that there is no evidence that private ownership has any discernible impact on productivity. So, although the authors agree that the private sector is unusually small in Bulgaria, Jones is not of the opinion that privatization and encouragement of the private sector are the answers to the country's woes. Policies to encourage all small firms, regardless of ownership, are his preferred focus of government efforts.

Another study using a simple econometric model to support the narrative is the Hinz and Ziegler paper on Germany. The authors have narrowed their focus to the determinants of start-up capital of newly founded firms. A representative city in each side of unified Germany is chosen for an east/west comparison. After giving us a break-down of what kind of new firms are being started in eastern vs. western Germany, they continue to the main part of the paper. Organizational factors, as well as personal characteristics of the founders, are used to explain differences in the amount of capital new firms start out with in Leipzig and in Munich. This information is definitely a contribution to the field, but it is left to the reader as to why the study is important, or how policy makers can use this new information to encourage the formation of new firms.

Respectable entrepreneurs will not just suddenly appear on the scene to form a class of small innovative firms, which is what Hans-Peter Brunner's chapter shows us, using the Polish experience. Additionally, even though prices and trade have been liberalized, resources have not moved from internationally uncompetitive sectors (as measured by value added) to a priori more competitive sectors.

Four stylized strategies for developing entrepreneurial potential are introduced: The "capital", "privatization", "nucleus", and "evolutionary" strategies. The "capital" strategy, based on the productive adaptation of large-scale enterprises, is dismissed immediately, using all of eastern Europe as proof. Brunner then cites the lack of a comprehensive microeconomic strategy as the cause of Poland's "privatization" strategy's failure, claiming that this strategy expects too much from the market in the absence of market institutions. Indeed, the lack of maket institutions has been cited by numerous authors within this book as well as by authors in other books[5] as a hindrance to firms entering the market. The "nucleus" strategy is rejected as a solution, using the German example to show that satisfactory results were not realized in that country either.

Brunner admits that the data are a bit shaky, but insists that entrepreneurs should be moving into other sectors in both of these countries. This conclusion is based on evidence showing the changes in the firm size distribution since 1990. Questionable here is the short period of time under investigation and the choice of sectors. Entrepreneurs in transforming economies surely encounter a good amount of friction and are limited in their mobility in the immediate future. This study may by more useful in 5 more years. Additionally, the claim that certain sectors are more competitive than others is driven by the traditional concepts of domestic resource costs and value added. According to recent work in this area, our previous calculations may have been misleading. By using *post*-currency union prices in her calculations, Helga Hessenius has shown that negative value added was not as large of a problem in East Germany as was previously believed.[6]

After rejecting three of the four strategies, Brunner adopts the evolutionary strategy as the best one. This strategy stresses the importance of industrial turbulence and a diverse industrial structure. Extensive work in the area of industrial turbulence has been done by Acs and Audretsch (1990). Growth centers are expected to emerge gradually from the existing industry structure.

An attempt at forming science parks as growth centers is covered in one of the more focused country studies. In keeping with the theme of small and new business in transforming economies, Bastone, Storey, and Westhead look at the support which small new technology firms in Russia are receiving from Russian science parks. This study fills a gap in the science park literature, which has focused on western market economies until now,, as well as a gap in the transformation literature, which has largely ignored the issue of building technology parks to encourage entrepreneurs in small new firms. The authors point out that Russian science parks are not like western science parks. One weakness of the Russian technoparks seems to be that may of them invest first, thinking of an application for the innovation later. However, they have the strength that they appear to have specialized in particular types of technology. As for the success of these parks, we will have to wait for more time to pass for more meaningful results.

The four years that have elapsed since market reforms were introduced in most post-socialist economies are not sufficient for drawing final conclusions about the transformation. Better data collection procedures will facilitate more reliable results in the coming years. This is not to say that economists should refrain from studying these economies now. Although this edited volume suffers from the present lack of sufficient data, it is more successful than previous collected works. Its more limited scope gives it more focus and the elapsed years since reforms were introduced give the authors room to analyse preliminary results. Such a compilation of studies is the kind of thing we should like to see periodically over the coming years for updates and new perspectives on the transforming economies in Eastern Europe.

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Notes

1 With some exeptions, of course. See Dallago *et al.* (1992) and Acs and Audretch (1993).

2 Fischer claims that the undervalued zloty caused higher inflation in the years following reforms.

3 The chapter by Ners, with its discussion of top down vs. bottom up transformation, doesn't seem to fit in with the rest of the book.

4 East German entrepreneurs are older and more highly qualified than their western counterparts. In addition, occupation during the socialist regime gives clues as to which sector nascent entrepreneurs will attempt to enter. The question of "who are the entrepreneurs?" has also been

addressed in previous literature (Kuczi and Vajda, 1990; Lengyel, 1989).

[5] See Knell, Mark and Rider (1992).

[6] See Hessenius (1992).

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