The Czech Transformation—An Institutional View

In this lecture I want to present the Czech transformation process from the point of view of the neoinstitutional economics. I will show that the transformation is just a special case of a noncontinuous institutional change.

The lecture is organized in a following way: In the first section I will sketch briefly the necessary theoretical background of the neoinstitutional economics. I will bring back the term *institutions*, and explain how they affect the economy. In the second section I will show that the Czech transformation can be seen as a special case of a noncontinuous institutional change. In the third section I will present some of the problems faced in the Czech Republic that are caused by a non-optimal institutional setting.

Institutions and Their Impact on a Society

First of all, let us briefly bring back the term *instituions*. In the English as well as in the Czech, the word "institution" has many different meanings. Basically, it can mean either some organization, or some rule, or some custom, and even some other things. In this lecture I will use the term *institution* in a more precise and technical sense. I would define institutions as *a set of formal and informal rules, including their enforcement arrangements* (Schmoller). The purpose of an institution is to steer individual behavior in a particular direction. An institution provides structure to everyday activity and thus reduces uncertainty (North).

Institutions are then the *sets of working rules that are used to determine who is eligible to make decisions in some arena, what actions are allowed or constrained, what aggregation rules will be used, what procedures must be followed, what information must or must not be provided, and what payoffs will be assigned to individuals dependent on their actions. ... Working rules are those actually used, monitored, and enforced when individuals make choices about the actions they will take.* (Ostrom)

Generally, institutions can be divided into two basic groups: to formal and informal institutions. The formal institutions are those that are specified and enforced by the government. The typical example of a formal rule is a law. The informal institutions are those not specified and enforced by the government. The typical examples are a custom, a "usual way", moral etc.

Institutions affect human behavior in two ways: First, they define the incentive structure of societies and economies specifically. It is obvious that a change of rules changes costs and benefits of any particular activity and in this way it changes incentives and motives of a maximizing subject too.

Second, institutions include also "public beliefs", ideologies, and other types of "theoretical glasses" through which human beings decipher the outer reality. These "glasses" determine what we can see—what activities seem to us to be profitable (worth of doing), and what internal (socialized) constraints we receive.

The result is that different institutional frameworks (i. e. different sets of rules) steer actions of the same individuals to a totally different activities. It is obvious that it has many political and economic consequences.

The simplest way to illustrate the impact of institutions on an economy is to build a very simple mental model. Let us suppose that there are only two types of activities: production and piracy. Maximizing individuals choose either to become businessmen (to produce), or to become pirates (to rob). What they choose depends on their preferences and on the expected costs and benefits (i. e. payoffs) of each of these activities and on their inner constraint (such as religious belief, morality etc.). Both the payoffs and the inner constraints are determined by the institutional framework the society faces. If the actual rules efficiently and severely punish piracy (i. e. make it very costly), and if most people share the belief that piracy is bad, there would be a very small number of pirates and a very big number of businessmen in the society. In the consequence the society could be relatively rich. If, on the other hand, the actual rules don't exclude piracy effectively (i. e. if piracy is a profitable business), and if there are very low internal barriers to become a pirate, there would be very many pirates in the society. In the consequence the society would be relatively poor.

The second country would be poorer than the first one for two reasons: First, some individuals (pirates) will not use their resources to the production. From the point of view of the society as a whole these resources are lost. Second, the other individuals must addict some of their resources to their protection rather than to production. From the point of view of the society, these resources are lost as well. If these resources were used in the production, the overall product would be higher. As Christians say, "sin is costly".

In other words, the society could reach the higher production possibility frontier (PPF) if there is less piracy. We could call the highest possible PPF (i. e. the PPF faced under the best possible institutions) to be *the technical PPF*. Similarly we can call the real PPF (i. e. the PPF faced under the actual institutions) to be *the structural PFF*. The difference between these two PPFs is determined by the actual institutional framework. The worse the institutional framework, the bigger discrepancy between the technical and the structural PPFs.

Up to now, our model was static. We expected no economic growth. If we include the economic growth into our simple model, we can see that the first (richer) society faces also a faster economic growth. The reason is straightforward: There are more stable property rights in the first economy. Therefore investments in capital, knowledge and technology is more profitable there—an investor need not worry that the future benefits of the investment will be robbed off him by a pirate. Therefore there would be more net investment in both the capital (human and non-human) and the technological improvement. The result is a faster capital accumulation and a faster technological progress in the first country.

Of course the situation in the real world is much more complex than in our simple model. There are many more activities than just the production or piracy. Therefore the institutional framework must be more complex too. But the basic conclusion still holds true: Institutions are crucial for economic life and progress. On the deepest level of explanation, it is the state of the institutional framework of a society that determines its economic performance and growth.

This theory corresponds very well with the observed facts: If we divide all countries into groups with the similar institutional framework, we can see that all countries within one group have very a similar economic performance, while there is a great discrepancy in the economic performance among those groups.

To sum it up: Institutional framework is very important, since it steers individuals when they choose what activities to undertake. This way it determines the overall economic performance of the country as well.

The Czech Transformation as an Institutional Change

The institutional framework is not constant, but it changes during the time. Usually the change is quite smooth and continuous, but sometimes (as in the case of revolutions) the change can be noncontinuous. This is precisely the case of the process usually called a "transformation" or a "transition" from a socialist society to a liberal (capitalistic) one—like the transition we could have seen in the Czech Republic in the last fourteen years. This "transformation" is from the point of view of the neoinstitutional economics just a special case of a noncontinuous institutional change.

From the institutional point of view, socialism is a specific setting of institutions. A setting that excludes private property, and tries to organize the whole economy as one firm. Beside the fact that this arrangement was not able to gather, use and share information well, it provided also a quite bad incentive structure. Individuals were motivated rather to cheat or even steel than to work and undertake a business in many cases. This spread of "piracy" made the economy relatively poor and inefficient, and it slowed down the economic growth too.

This progressive stagnation was probably the main reason why most people were in the 1989 ready to remove the socialist institutions and to replace them with relatively standard liberal (capitalistic) ones. It is the laissez-fair system that is traditionally viewed as the most efficient set of rules; at least we can see that those countries (e. g. the USA) that have (or had in the past) the institutional framework closest to it are now the most rich and the most rapidly growing.

The transition from the socialist society to a liberal one is then simply an attempt to replace the socialist institutions with the laissez-fair ones.

At the first glance it may seem that such an institutional change can be done very easily and rapidly, but it is not the case. First of all, only *formal* institutions can be changed rapidly—by the stroke of pen of the president. Informal institutions, i. e. all habits, customs, approaches, beliefs and moral sentiments cannot be changed this way. It takes a lot of time for them to adapt to the new formal rules and to support them efficiently. Human hearts and minds cannot be changed swiftly. In the meantime, which could take many decades and in some cases even centuries, there can be a struggle between the new formal and the old informal institutions.

This is also the reason why even the formal institutions cannot be simply translated from one country to another one. The actual performance of the formal institutions depends also on the informal ones. Therefore the same law can have quite different consequences in two countries with different set of informal institutions. That is why it was not possible to simply transfer the German or the US civil code into the Czech Republic. It would not work well. Some new set of formal rules appropriate for the Czech Republic must have been found.

But developing the new set of formal rules that should imitate outcomes of the rules that evolved in the free countries for centuries is a very hard task since no one can predict precisely the actual outcomes of any particular rule before it is installed. The only way is probably to play a game "try—and learn from your errors".

We have to keep in mind too that many possibly improving changes of formal rules could not have been done because they were not politically viable since strong pressure groups resisted the change—either because their particular interests were threatened by the proposed rule, or simply because they thought so.

Therefore it is obvious that many particular rules must have been set sub-optimally in the process of transition. Any such sub-optimality offsets the structural PPF from the technical one, i. e. it lowers the net national product and slows down the economic growth. We can see many such sub-optimalities in the Czech Republic now (some of them will be explored in the last section of this lecture). But from my point of view, it is almost a miracle that in such a short period of time (in approximately five years) we were able to establish the core of the necessary formal rules needed for an efficient performance of the liberal society. As for the rest, there is still a great deal of work to do.

Some Institutional Problems of the Transition

In the rest of this lecture I will sketch some of the most painful problems of the transition—seen from the perspective of the neoinstitutional view. I will explore the following three topics: The privatization process, the problem of the bankruptcy law, and the problem of the incomplete legal enforcement.

The Czech Privatization Process

The privatization was one of the key parts of the necessary institutional change in the Czech Republic. Before that almost all firms were owned by the government and controlled by a special class of bureaucrats according to a central plan. As I have already said, this system was inefficient—first of all because it was not able to provide the central planers the necessary information and second because it provided individuals with inefficient and undesirable incentives (from the point of view of the society as a whole).

The privatization of the state property was necessary then. The only question was *how* to privatize it. There were many possible ways to privatize the state-owned firms: For example, the firms could have been first restructured and then sold to an "socially optimal" owner, as is now proposed by some critiques of the actual privatization process. But this idea neglects the problem of missing knowledge. Who could say what structure of a firm is optimal for the developing market economy? No one could—for exactly the same reason why no one was able to control the former command economy. This is absolutely the same problem of the absence of distributed market knowledge that makes the socialism impossible. The only possible way to find out necessary information is through experiments and the market competition process—only successful well-adapted firms survive through the time. And only a private owner has the right to experiment (and possibly fail). No state officer has the necessary knowledge, the desirable incentives, and the right to do it.

Another problem of this way is that it creates an opportunity for a gain from corruption.

Other possible solution was to sell all companies to a foreign buyer who was willing to pay most. The economic theory usually predicts that who is willing to pay most would be the best owner. This approach was used (successfully) for the privatization of some huge firms (e. g. Skoda Motors). However, in most cases this approach was not politically viable—there was a strong pressure against selling “a family silver” to foreigners. Moreover, probably only big firms could be sold this way and even in their case the privatization process could take a long time.

But there was a reasonable effort to privatize most firms as fast as possible. The theory of corporate governance predicts that firms’ managers (as the agents of the firms’ owners) act according to their own interest rather than according to the interests of the owners (the principal) if they are not constrained properly. The period of time between the end of the socialist state control and the beginning of an efficient control of a new private owner is precisely the time when managers are very poorly constrained and can act in a socially undesirable way—they can even rob the firm off transferring its assets to their own new firms. Moreover, since the position of the former managers is weak when the firm is to be privatized to a skilled foreign investor that is supposed to install his own experienced management, the present managers have also very weak incentives to manage the company in the way that allows it to survive and even to expand. These corporate governance problems of firms before their privatization are sometimes called “privatization agony”. They constitute a good reason to reject all “slow” ways of privatization.

In practice it means that most firms must be privatized as quickly as possible to any Czech citizen (as foreigners are politically undesirable) without any previous restructuring. It must be expected that an efficient ownership and structure of a firm, its strategy, product mix etc. would be found later on the market through the competition filter. It must even be expected that many of these firms would not survive and their owners would experience the loss of their assets.

This very approach has one more very strong limit: There were almost no wealthy people in the Czech Republic. Simply, there was not sufficient capital to buy all those privatized firms in the country. Therefore firms had to be either paid using leverage or simply given the citizens for free (or almost free).

Within these limits three basic methods of privatization were used: The privatization by sale, the voucher privatization, and the re-privatization (so called “restitution”). The privatization by sale was used within the so called “small privatization” and partially in the so called “large privatization” too. The voucher privatization was a part of the “large privatization”. The re-privatization was done separately—some of the property “nationalized” by the Communist Party was returned to its former owners and their descendants. The re-privatization is usually supposed to be the most successful part of the whole privation process although it was not planned by the government at the beginning—government was even forced to it by public opinion.

Privatization by Sale

Let us explore the two other parts of the privatization process in more details. Let us begin with the privatization by sale. With this method, firms were offered for sale. They were possibly divided or restructured a little before the sale according to a “privatization project”. Anyone was allowed to propose any privatization project for a specific firm he wished (even more than one project).

Since there were very few wealthy people in the Czech Republic, firms must have been usually paid using leverage. The credit was usually given by state-owned banks. (For some reason banks were privatized much later, after privatization of almost all other firms.)

It is obvious that in this privatization procedure the former managers and some employees of the firm had an advantage because they had knowledge superior to the rest of the population. The former managers (socialist bureaucrats) had one more advantage too: They had better access to the credit since bank officers that allocated the credit were former socialist bureaucrats too—often their friends and acquaints from the Communist Party meetings.

The actual way of this procedure created a great opportunity for a moral hazard and even for a criminal activity. It was beneficial for the owners of a new-privatized firm paid almost solely using leverage funded by a post-socialist state-owned bank to create another firm with a similar name and activities and to transfer assets, contacts with customers etc. to the new firm. If the former firm was a public limited company (or a similar legal form), its owners simply let it go bankrupt—in this way the loss was transfered to the bank and its customers which would only get the rest unprofitable assets.

The institutional framework was insufficient in those days to protect the creditor (here the banks) against such activities. The informal institutions did not exist yet since it takes a lot of time for them to evolve. The formal ones worked inefficiently. Later we will see that the inefficient legal enforcement is the problem in the Czech Republic even nowadays.

It is hard to estimate the number of companies robbed this way by their owners and managers since some of the failed firms went bankrupt because of a poor management or even because of a bad luck rather than because of any criminal activities.

Let us complete the story. In the process of transition banks had a very big share of a bad credit—either because of criminal activities or for any other reason (such as missing banking know-how or because many firms had problems caused by the transition themselves). The government did not want the banks to fail—at least not the big ones—and saved some them. It bought the classified credit. In this way the problems of companies were shifted to the taxpayers. This was also true for many firms that were (by politicians) supposed to be “too big to fail”.

Despite of many problems stated above, this privatization process started the Czech economy. Many (maybe most) new-privatized firms survived and were in some time able to produce a profit. They were able to adapt themselves to swift changes of the outer environment, to export to the rich western countries and are nowadays able to survive even in the competition of the European Union. This is true even for those firms that have their origins in the criminal or suspicious activities of their owners. The main goal of the privatization was thus reached. We had to expect that this process would be costly and sometimes “dirty”.

But the suspicion that the wealth was gained in the privatization by “dirty” or even criminal activities has its bad consequence too. First, it spoils the informal institutions because it makes an impression that these activities are socially acceptable. In this way it weakens the incentives to undertake and strengthens the incentives to “rob”—even to use the government for a transfer of wealth. Second, it reinforces the ideas to reinstall the socialism again. We can see that the preferences of the Communist Party have risen in last few years. It is certainly partially because of the "dark side" of the privatization process.

The Voucher Privatization

In the voucher privatization, all citizens who wanted, were given "tokens" (more precisely, the tokens were sold to them for the administrative fee 1 000 Czech crowns). These tokens were used in auctions—citizens bid tokens for shares of big firms. If the demanded quantity of shares was higher than the supply, the "token"-price of one share went up; in the opposite case it went down. There were many "rounds" of the auction to sell as many shares as possible. Since the book value of the shares per capita was in general much higher than the administrative fee it was rather a gift then a regular auction.

The goal of the voucher privatization was to privatize the most firms as fast as possible to make the "privatization agony" as short as possible and to start the economy as fast as possible. Moreover, the government wanted this way to win the loyalty of its citizens to the new regime (it was supposed that the new shareholders, i. e. "capitalists" would not support the return of the socialisms).

As for the ownership structure, it was supposed that it would evolve after the privatization—that the new shareholders would either try to manage the firms themselves or sell their shares to those who would like to do it. This way the firms could be sold indirectly even to foreign investors—if the new shareholders would sell their shares on the stock market to them. According to the Coase' theorem this way should evolve the efficient ownership structure without any prior knowledge what it was.

The government supposed that the first ownership structure would be extremely diversified. But this was not the case in reality. A new—non-expected—type of firm evolved—a privatization fund. These funds were similar to closed mutual funds known in the developed countries. They attracted a great share of all "tokens", and thus they became big players in those auctions.

What happened was that the concentration of the ownership took a lot of time. Small investors (the citizens that invested through the voucher privatization) were not able and even willing to manage the companies; the big players (i. e. privatization funds) were not willing to manage the firms as well because they were just portfolio-investors. Therefore managers of the new-privatized firms were very poorly constrained and the "privatization agony" existed even after the formal privatization.

The corporate governance theory says that the managers can be constrained pretty well even if the ownership structure is extremely diversified if the capital market works efficiently. But this was not the case of the Czech Republic. It was the voucher privatization that created and started the stock market.

After all, the concentrated ownership structure was created in some years after the voucher privatization. It probably took a longer time than was expected. It is hard to say now whether the rise of the privatization funds accelerated or slowed down this process. But as in the case of the privatization by sale, many (maybe most) companies survived and became able to export and compete even in the markets of developed western countries. Thus the ultimate goal of the privatization process was reached. The only question is whether there was a better (i. e. less costly) way to do it, or not.

The Czech Bankruptcy Law

One of the most important institutions of a market economy is the bankruptcy law. A poorly managed firm must be liquidated and its assets must be transfered to profitable (i. e. well-managed) firms. This is the way the market process seeks the efficiency. If the bankruptcy law is weak, or if it prefers the debtor to the creditor, or if it is enforced by the legal system inefficiently, the market process is violated. This is precisely the case of the Czech Republic.

In the Czech Republic the bankruptcy law is one of the poorest part of our legal system. The Czech Republic is often criticized for it. The original law was set in 1991. It has been changed twenty one times since the 1993 (ten times since the 2000). Now the law is quite complicated and the process of bankruptcy is complicated and slow as well. The law prefers the debtor to the creditor in many cases. And what is even worse, there is a great discrepancy between the text of the law and its use.

The number of non-completed bankruptcies is ever-rising. Each year the number of non-completed bankruptcies rose by one or two thousands (from 1994 to 2000). In the 2000 there were 2 491 new bankruptcies, and 10 560 non-completed ones.

There are also known cases when the liquidator (the trustee in bankruptcy) and his friendly judge willingly slow down the bankruptcy process to rob the company-in-the-bankrupt themselves.

Let us explore the impact of the poor bankruptcy law on the economy more precisely.

First of all, if the bankruptcy law is poor, the recourses cannot be allocated properly in the economy. There is no limit to wasting (i. e. making a loss), and there is also no force that would shift resources from those who misuse them to those who use them efficiently. Thus also the market quest for the efficient ownership structure is violated.

In the transition it is even worse since the transfer of assets from one firm and one owner to another is the key mechanism that establishes the efficient ownership structure. If this process is violated the efficient ownership structure would be reached much later than it could be.

Moreover, if the bankruptcy law is poor, financial problems of one firm can be spread through its supplier—consumer connections to many other firms. This way even a well-managed firm can become illiquid or even insolvent making the same problems to still more firms. This was an important problem in the Czech Republic in the process of transformation.

Until now we have been treating the payment problems that were caused by either bad luck or a poor management. But if there is a poor bankruptcy law, there is a strong incentive for moral hazard too. A debtor may borrow with intention not to pay back in the time or even not to pay back at all. This always has disastrous economic consequences, but in the time of privatization it may become a really important tool of transfer of wealth as I showed above.

There are of course many more problems caused by the poor bankruptcy law. For example, a credit is more costly (the interest spread is higher), and some possibly honest and productive debtors cannot get a credit since they have not sufficient collaterals. It is obvious that it lowers the aggregate investment, and thus it slows down the economic growth.

Incomplete Legal Enforcement and Inefficient Laws

The poor bankruptcy law is just a special case of an inefficient enforcement of the law and of inefficient laws. In the Czech Republic (and probably in the most transition countries as well) the legal system is inefficient. It takes long time until the court makes any judgment, and very often the judgment is in contrary to the justice in a common sense. There are many reasons for it: First, most judges are the former communistic bureaucrats—there was no "denazzification" of courts in the Czech Republic after the revolutionary changes in 1989. There is also a very weak control of the performance of judges. Their lobby usually says that such a control would break the necessary independence of courts. The courts are also organized in an inefficient way, and the process law is inefficient as well. These are the major reasons why the legal process is extremely slow in the Czech Republic.

Second, some laws are inefficient. Sometimes because the efficient code has not been found yet, sometimes because this inefficiency was designed for the benefit of some strong pressure group.

Third, the traditional way of interpretation of law in the Czech Republic is extremely *legalistic*. Judges are acting according to the words of the code rather than its spirit according to a common sense and common notion of morality. Thus any criminal activity that is not covered in the code in an *explicit* way could not be sanctioned.

What are the results of this inefficient legal environment? If there is an inefficient legal enforcement (as it is in the Czech Republic), the case is similar to our mental model of piracy. The less efficient legal enforcement, the more pirates. Then the transaction cost rises reasonably. It means first of all that more productive resources are used not for a production but for a transacting and a protection. The more resources are used this way, the farer is the structural PPF from the technical one. Some transaction possibly beneficial for both parties cannot be done because it is not beneficial if the high transaction cost must be paid. This offsets the structural PPF even farer from the technical one.

Moreover, the inefficient legal enforcement also lowers the expected return on an investment. The aggregate investment is then lower then it could be otherwise, and the overall economic growth rate is then slower. Many foreign investors can also choose another country for their investments (with the same effect).

In the process of transition the inefficient legal enforcement may have also another consequence: a great part of the total "national" wealth is transfered through criminal or "dirty" activities. This has some undesirable impacts on informal institutions that I pointed above.

There are also more problems with the legal system in the Czech Republic. In the transition many law codes must have been changed, some of them many times. This has two unpleasant consequences: First of all, the legal environment is unstable, which increases the risk of any long-run investment, and thus it lowers the aggregate investments and slows down the economic growth.

Second, when many law codes change, and change often, the cost of such a change is extremely low. Then it also may be profitable for some special-interest pressure groups to try to change the law for their benefit. The results of this are inefficient laws and resources directed rather to rent-seeking and similar activities than to a production—with obvious consequences for the economic performance and growth.

Conclusive Remarks

It is obvious now that the transition process is a case of a noncontinuous institutional change. A great part of this change is a change of the ownership structure. Generally, the ownership had to be changed from the "national" one to the private one. The less obvious is how to do it. Some attempts were tried in the Czech Republic and in some other countries. There are some general points that should be remarked.

First, a government should not probably try to restructure firms before the privatization because it has not got the necessary information to do it properly. It also creates an opportunity for a managerial discretion, corruption etc.

Second, there probably must be some time of "privatization agony"—either before a privatization (in the case of a slow one), or after it (in the case of a fast one, e. g. the voucher one). This is inevitable. We can only influence the length of the "agony" choosing some particular way of transition. More empirical and theoretical research is necessary to solve the question what way of privatization is the less costly, i. e. shortens the agony as much as possible.

(I have to remind you that we cannot compare the actual way of the transition and some ideal theoretical one. We have to compare only two strategies that can be applied in the same country in the same time—and in a really applicable form.)

Third, every non-adapted institution (either formal or informal one) negatively affects the process of the transition. Banks cannot be privatized before other firms and the stock market cannot be established before many firms are private; but the privatization itself is much slower and more costly if there are only state-owned banks and no stock market. This is an Gordian knot—it cannot be cut optimally, but we must start somewhere.

Fourth, the state of law (i. e. formal institutions) is of a key importance both for the transition and for the following economic performance. In the Czech Republic the bad-working bankruptcy law and slow inefficient legal enforcement has an important negative impact on the economy. It increases the motivation to moral hazard and allows to spread one firm's problems through supplier-consumer connections in the economy. It slows down the performance of the market competition filter too. It is a great problem for a stabilized economy, but it could be disastrous for a transitional one, since it can prolong the "privatization agony" and even block the necessary changes in the ownership structure.

Fifth, all these problems have not only its direct negative impact on the economy, they affect also the present evolution of the institutional framework—that will affect the economic performance in the future. Many harmful institutional changes were intended as a cure of problems caused by former harmful institutions. This way the path dependence comes to play the vital role.

There are many other institutional problems too: Inefficient governmental economic regulation (they have tightened and tightened it in the last years), high taxes and complicated inefficient tax and social-welfare system, instable legal environment etc. But these problems are quite beyond the scope of this lecture. Moreover, they are not specific for the transitive countries—they can be found in all developed countries of the world.

But what we always have to keep in mind is this: the "total" privatization in the former socialist countries is a quite different process than a "partial" privatization in a market economy, e. g. in the Great Britain. There are not sufficient skills, not sufficient capital, no market prices, no capital markets (and stock exchanges), no private banks, not appropriate institutions in the former socialist countries. The usual way of a smooth adaptation of institutions and a market privatization selling a firm's shares at the stock market to investors, both domestic and foreign, is not possible here. Some new and possibly strange techniques must be used in these countries—necessarily being suboptimal in comparison with the techniques used in the developed market countries.