



PRIVATE SECTOR DEVELOPMENT

Entrepreneurship and Transition¹

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Abstract. While output and employment in the overextended and overmanned state sector decrease, it is crucial for the success of transition that private entrepreneurship builds up, increasing production and employment, in a process somewhat paralleling the dual development Harris-Lewis-Todaro model, where the state sector plays the role of the traditional sector endowed with an almost unlimited reserve of labour. The way this takes place depends to a great extent not only on the specific features of the privatisation processes pursued, but also on the overall institutional and social conditions affecting the development, and the nature, of private entrepreneurship. In particular, under conditions of insufficient construction of the institutional framework of the market, and lack of prevention and punishment of fraudulent behaviour and self-dealing, the development of entrepreneurship can be derailed into unproductive and destructive forms, according to Baumol's distinction, with dire economic and social consequences. The different outcomes of the transition process may also be explained through the different preconditions affecting the severity of the specific impediments encountered in development of entrepreneurship. Some policy suggestions for speeding up this development, both in quantitative and qualitative terms, conclude the paper.

Key words: employment institutions, entrepreneurship, transition

1. Introduction

The main objective of this paper is to consider the specific obstacles to development of entrepreneurship in economies in transition and how they can be overcome. In particular we consider the impact of the specific environment of transition on the supply of entrepreneurship, both in its quantitative and qualitative dimensions, and the role of entrepreneurship in employment creation. In this we shall refer to a rather limited but burgeoning specific literature on the issue, often contained in unpublished working papers, as well as to the more general sources concerned with the overall issue of entrepreneurship and its promotion.²

¹ Some ideas contained in this paper were first presented at the Fourth International Conference on "Enterprise in Transition", Hvar (Croatia), 24–26 May 2001. I am indebted to the organisers of the conference for having stimulated my research interest in this area.

² For a wider perspective on the latter, see in particular OECD (1998).

2. Demand for Labour and Supply of Entrepreneurship

One of the main issues in transition economies is how to compensate for the contraction in employment of overmanned state firms. The most obvious answer lies in the development of entrepreneurship. Indeed, demand for labour is intrinsically derivative from entrepreneurship (where by entrepreneurship we may understand the activity of launching as well as that of running a firm).³ Increasing the supply of entrepreneurship (the number of those who are willing to perform as entrepreneurs and the size of entrepreneurial activities) and the quality of entrepreneurship (the quality of their activity, which, among others, depends on the incentives for entrepreneurs to perform effectively) enhances the capability of the economy to create and maintain jobs. This remark should be obviously qualified by paying due consideration to the opportunity cost and capabilities of would-be entrepreneurs (not everybody has the capabilities for becoming an entrepreneur, and some who have those capabilities may perform relatively better in alternative occupations).⁴ But the importance that the development of entrepreneurial activity has for a successful market economy, and especially for a market economy in formation, where entrepreneurial capabilities are scarce and potential entrepreneurs are mostly devoid of specific experience, can hardly be exaggerated. Moreover, creation of employment is the first immediate consequence of the creation of new enterprises or of the growth of existing ones.⁵ Broadening the perspective, “in any economy, however organised its economic institutions, it is enterprises and the

³ As a matter of principle there is a distinction to be made between the entrepreneurial and the managerial functions. For instance, this distinction is clearly stated by Baumol (1968, p. 64), following the lead of Schumpeter: the manager is “the individual who oversees the ongoing efficiency of continuing processes”, while the job of the entrepreneur is “to locate new ideas and to put them into effect” (p. 65). In practice it may be difficult to clearly distinguish the two functions. Moreover, the same agent can be involved at different moments in the one or the other. “Continuing processes” may involve the continuous development of new ideas, and piecemeal innovations can be adopted in the framework of “continuing processes”. Here we adopt *Merriam-Webster’s Dictionary’s* rather wide connotation of the entrepreneur, as “one who organizes, manages, and assumes the risks of a business or enterprise”. As a matter of fact, in presence of a somewhat hazy and controversial concept, there is some merit in adopting its common language connotation, as it could be found in an authoritative dictionary source. For a discussion of the different possible concepts of entrepreneurship and related statistical measures, see Verheul and others, 2001, pp. 4–5. Cf. also the review of the different conceptions of entrepreneurship in the history of economic thought in Hébert and Link (1989), or Bink and Vale (1990, pp. 9–21).

⁴ For a general equilibrium approach to the issue of the determinants of the choice of becoming an entrepreneur and of the market failures leading to inefficient professional choices, in particular because of the relevance of family background and inheritance, in a context of imperfection of capital markets, see Li (1997), and the literature quoted there.

⁵ Here some caveats, as is always the case in economics, are in order. An enterprise may well grow as to the size of its capital, but contract as to its employment. Moreover the creation (or enlargement) of a new enterprise could (but need not) lead eventually to the reduction of employment in enterprises that are affected by the competition of the new (or enlarged) one: this reduction could in theory be greater than the employment creation of the latter, but in practice this may be the exception rather than the rule.

entrepreneurs, whether self-employed only or those also employing hired labor, whether privately or collectively owned, which create most of the economic value-added. Although the organisational structures of firms vary greatly among countries at different stages of development, it is entrepreneurship which is the jobs, growth and welfare creation engine.”⁶ Here we must be careful to distinguish between entrepreneurial activities, and the entrepreneurs. The former may be performed by employees who are not entrepreneurs in a subjective sense, because they do not work on their own account, but still exert an entrepreneurial function, such as managing innovations or organising the firm, and it can be performed collectively, by partnerships, organisations and committees rather than by individual entrepreneurs. Moreover entrepreneurial activities can be performed only occasionally. Entrepreneurship can be performed to some extent not only, say, by the founders in charge of an enterprise, but also by venture capitalists, such as the so called business angels, who not only are sharing in the entrepreneurial function of risk taking, but are involved in the assessment of entrepreneurial prospects and may variously affect the decisions relating to the running and development of the firm.⁷ Indeed, the issue of defining and especially measuring entrepreneurship is rather murky and not easily amenable to consistent and empirically relevant definitions in substantial agreement with the common meaning (or meanings) of the term. We shall return to the issue in Section 3.4.⁸ As far as the countries in transition are concerned, “in the most advanced post-Communist countries of Europe . . . whereas jobs have been lost massively in the large enterprise sector throughout the 1990s, the dynamic growth of the small business sector has not only been the chief factor driving economic growth since 1992, but has also served to absorb much of the unemployment created by the shrinking of the state sector”.⁹ In a way, the state sector provides, in the first years of transition at least, an almost unlimited reserve of manpower (as well as of potential entrepreneurial talents) for the spontaneous growth of the entrepreneurial private sector, performing an analogous role as the traditional sector in the Lewis-Harris Todaro model of dualistic development.¹⁰ This process should be appreciated against the background of the very unbalanced structure of entrepreneurial organisation under the previous system, with what seems an abnormal concentration of economic activity in big firms, from the perspective of a market economy, while this kind of concentration was functional to the central management of the former planned economies.¹¹ Unfortunately, in

⁶ Ilmakunnas et al., 1999, p. 2. Employment can also be created by the state administration. But the basic resources that are necessary for its financing, and which are drawn through taxation, are directly created by the enterprise sector itself.

⁷ Cf. OECD, 1998, pp. 18, 100.

⁸ On the difficulties of defining and measuring entrepreneurship see OECD, 1998, pp. 35, 40–46.

⁹ Woodward, 2001, p. 1904. See also Kolodko, 1999.

¹⁰ Cf. Chilosi, 1993, p. 73.

¹¹ Some data relating to manufacturing employment are provided by Acs and Audretsch (1993, p. 228). For instance, in 1988 in Czechoslovakia the share of employment in small firms (with less than 500 employees) was only 1.4%, in 1986 East Germany, 1.1%. In 1985, in Poland, which was

the less successful transition countries, and even in the more successful ones at the beginning of transition, this process has been defective, owing to barriers of various natures encountered by entrepreneurship.¹² The limitation in the supply of private entrepreneurship can be considered perhaps the principal factor conditioning the extent of the postsocialist depression, until the private supply of entrepreneurship starts to be a match for the decline in public entrepreneurship associated with the decay of the public sector, following the dissolution of the socialist regimes.

3. Wealth, Entrepreneurship and Transition

3.1. *Wealth and Business Financing*

Entrepreneurs usually need to command resources to establish and run an enterprise or to acquire control of a partnership with which to perform the entrepreneurial function, or to increase the dimensions of their enterprise. The higher the level of entrepreneurship, as measured by the size of the firm, the greater the resources that entrepreneurship may require. As a matter of principle these resources could simply be borrowed. Thus, this fact would not be an obstacle to entrepreneurship if financial markets were perfect, opportunistic behaviour could be ruled out, and the prospects, as well as the risks, of entrepreneurial initiatives were easy to gauge. In the reality of the world all these circumstances do not apply. Markets for loanable funds are imperfect and restricted in scope. Even the most developed financial markets are far from being complete: the types of transactions that can be carried out are intrinsically limited. Information is asymmetric, and opportunistic behaviour possible and, sometimes, frequent. Because of this financiers usually require that a certain percentage of the capital of a firm be provided by the owner¹³ or that the owner is able to supply sufficient guarantees as to the repayment of loans independently of the success of the enterprise or, at least, to limit the risk of the lender with the collateral he is able to provide. Financial resources cannot be freely borrowed, but are rationed because of adverse selection motives: often one cannot borrow more resources simply by accepting a higher rate of interest than for loans of lesser risk.¹⁴ Even if one can envisage leaving to hired managers, as distinct from owners, the main current entrepreneurial functions of established enterprises, the usual agency problem applies in pointing to the suitability of top managers having an adequate personal stake in the firm. (The

much more permissive than most of the other former socialist countries towards forms of small private enterprise, the share of employment provided by small firms (less than 100 employees) was 10%, down from 33% in 1937. For a comparison, the share of employment provided in the same years by small firms (with less than 500 employees) in OECD countries varies from 35.2% in the USA (1987) to 71.8% in Portugal (1986).

¹² Cf. Bartlett and Bukvić, 2001.

¹³ On this point one may in particular refer to the pioneering treatment of Breit (1935).

¹⁴ See Stiglitz and Weiss, 1981.

lack of a personal stake in the long run success of firms by those who control them may be considered as a basic drawback of state-owned enterprises, which may explain to some extent their overall failure to match the performance of privately owned ones.) Thus, those starting a new enterprise or investing in an existing one must usually put their own capital at risk. As Kalecki (1937, p. 289) puts it: "The enterprises started in a given industry at a given moment are not of equal size because the private capital of the various entrepreneurs is not the same. 'Business democracy' is a fallacy: the amount of the entrepreneur's private capital is a 'factor of investment'." Such considerations are confirmed by the more recent literature, both theoretical and empirical. Indeed, "there is a positive correlation between the probability of becoming an entrepreneur and individual ownership of assets", "business investment size is positively correlated with an entrepreneur's net assets" and "business exit rate is negatively correlated with an entrepreneur's net assets".¹⁵ "Entrepreneurs with more assets will be able to borrow more collateralised loans, therefore the cost associated with external finance are smaller for them. Comparing two entrepreneurs with the same productivity shock, the one with higher assets will invest more in his business, and he pays a lower average interest rate on his loans".¹⁶ According to the empirical enquiry of Evans and Leighton (1989) based on American data, "men with greater assets are more likely to switch into self-employment all else equal. This result is consistent with the view that entrepreneurs face liquidity constraints" (p. 520). However, the effective relevance of this type of constraint, in advanced market economies at least, is controversial. According to an enquiry in the USA, quoted in OECD, 1998, p. 254, "small businesses on average rank obtaining long-term or short-term loans as only 63rd and 64th respectively on the list of difficulties they face". Analogous results are quoted for other surveys in Sweden, Australia and the Netherlands. In less advanced and transition countries one would however expect these factors to be of much greater relevance, owing both to lower levels of personal wealth and to the much greater imperfection and much lower extension of financial and monetary markets. At the same time, as we will discuss later on, it seems that in several instances the short side of the credit market in transition countries is demand, and credit is limited because it is not asked for. What has been said about loans obviously applies, *mutatis mutandis*, to all sorts of venture capital: the capitalisation of the enterprise and the wealth of those who are in control (besides their personal reputation) are of great relevance in deciding whether and how much to invest. It should be also considered that the need for funding to start a business refers to two kinds of financing. A first type is related to the preference the entrepreneur has for not liquidating his illiquid assets, even if the funds borrowed are entirely covered by his wealth.¹⁷ Borrowing could then be entirely collateralised (but lending would usually be lower than the value of the collateral if the bank wants to be covered for the costs it would incur to

¹⁵ Li, 1997, pp. 2, 4.

¹⁶ Ibidem, p. 18.

¹⁷ Cf. Binks and Vale, 1990, p. 141.

liquidate the collateral in case of default, as well as for the possible oscillations of the price of the collateralised asset). This would keep the risk and the costs of lending to a minimum. Moreover, there would be no particular need for the bank to assess the validity of the entrepreneurial project, but only the value of the collateral. Even less experienced banks, such as those of transition countries, would be able to manage this type of banking (except for the greater uncertainties as to the possible value and liquidity of the collateral). Another kind of loans are those that are not covered by collateral and require a deeper assessment of the entrepreneurial project and of the personal characteristics of the borrower. This kind of much more sophisticated financing may be particularly difficult in transitional economies, and, for this reason too, the wealth constraint could be especially biting. In case of corporate entrepreneurship the limitations of the financial markets are certainly more binding than in more advanced countries and the size of the capital directly contributed by partners or main shareholders is all the more relevant. The risk faced by entrepreneurs and financiers alike is all the greater if there is insecurity of property rights¹⁸ and if the assets which are constructed by the entrepreneur through his investment and personal efforts cannot be easily liquidated, in case the entrepreneur chooses, or is forced to do so in order to maintain solvency. Another relevant component of risk is the uncertainty as to the effective burden of the service of borrowed funds due to the variability and degree of unpredictability of inflation that is usually positively associated with its level,¹⁹ and with lack of intertemporal consistency in public policy. This is a reason why entrepreneurship may be negatively related to financial instability, such as often prevails in transition countries. More generally, the less stable and predictable the overall policy framework, the greater the entrepreneurial risks that may thwart the supply of entrepreneurship.²⁰

3.2. *Difficulties of Financing as Hindrance to Entrepreneurship in Transition Economies*

Thus, the obstacles on this account are particularly great in the case of transition economies because of the following specific factors: (1) financial markets are in most cases very restricted and underdeveloped; (2) the banking system is highly

¹⁸ As Johnson, McMillan and Woodruff (1999, p. 1) put it, "Property rights are fundamental: people will not invest if they cannot keep the fruits of their investment", even if "the insecurity of property rights does not completely stifle investment". The relevance of this type of constraints for the economies in transition is emphasised by these authors, in opposition to the liquidity, or banking constraint emphasised by Holmström (1996).

¹⁹ Cf. for instance Bruno (1995).

²⁰ See also OECD, 1998, p. 14: "Entrepreneurial activity is significantly easier to carry out in a stable macroeconomic environment with low inflation: this allows entrepreneurs to clearly interpret signals about demand and prices and makes it possible for them to develop sensible business plans and strategies based on the fundamental strengths of their projects."

concentrated and particularly inefficient;²¹ (3) moral hazard problems and the risk of opportunistic behaviour (not only by private agents, but the “grabbing hand”²² of the state as well) are especially high because of greater imperfection of the legal framework and less effective application of the law, and because established codes of behaviour functional to the modern market economies are wanting, since they can be developed only through long years of practice and experience, the practical counterpart of the indefinitely repeated non-cooperative games of the theory. Moreover the initial stages of transition, involving price liberalisation in a context of financial imbalance, often lead to very high inflation, which requires a great deal of toil and single-mindedness by the authorities to curb and control. Oscillations of policies in this respect can be very damaging by increasing the overall uncertainty under which enterprises operate.²³

The above factors may be particularly damaging for the establishment of new firms, or for bringing about, through investment, a jump in the dimensions of existing ones. However, once a firm is established and makes adequate profits, it can enlarge its dimensions gradually through retained earnings.²⁴ According to the results of “a 1997 survey of recently formed manufacturing firms in five transition countries” by Johnson, McMillan and Woodruff (1999, p. 1), under the conditions of transition countries internal finance takes the place of external finance.²⁵ In general, however, internal finance could be a complement of, rather than necessarily a substitute for external finance, since internal finance increases the potential for tapping outside finance. But if leverage is small or non-existent (because of the absence or rudimentary development of financial and credit markets), private wealth becomes a much stricter pre-requisite for entrepreneurship, since it turns

²¹ In the *EBRD Transition Report 2000* the scores for “Banking reform & interest rate liberalisation” and “Securities markets & non-bank financial institutions” are on average particularly low (15 countries out of 26 have a score less than 3 for the first index, 20 countries have a score less than 3 for the second, in a range between 1 and 4+, much lower, for instance, than the score on privatisation).

²² See Frye and Shleifer (1997).

²³ A straightforward example in this respect is provided by the case of Bulgaria. In 1995 Bulgaria seemed to have overcome the worst of the transition crisis. All was lost by a policy reversal in 1996 that had dire overall economic and social consequences. To this one may contrast the successful case of Poland, where notwithstanding frequent changes of parliamentary majorities, there was a consistent albeit, after 1990, gradual process of reduction of the inflation rate, from 586% in 1990 down to 7.4% in 1999.

²⁴ Thus the creation of a new firm is a lumpy qualitative jump. The subsequent growth of the firm can be the natural by-product of its profitable activity. This justifies some policy measures for helping the creation and development of firms in their first more difficult period of their existence, in name of the promise they can bear for the future.

²⁵ Holmström (1996, p. 207) quotes a 1988 study by Colin Mayer, according to which in the non-financial sectors of various Western economies “approximately 70% of investment into physical capital is financed by retained earnings”. Thus retained earnings constitute on average a most important source of financing in the West too. In order to appreciate the relevance of the banking sector and the financial markets, however, one should consider that a consequence of their development is to make firms potentially more liquid (or rather less illiquid), greatly reducing entrepreneurial risk.

out to be the almost exclusive source of financing. On the other hand in transition countries “often loans were not made because the firms did not want them. The limited use of external finance by firms . . . reflects not just a lack of loan supply but also a lack of loan demand”.²⁶ This depends on the high cost and risk of finance, due to a number of factors, such as the high cost of intermediation due to the low level of development of the banking sector and the high level of risk faced by banking activity, which results in high risk premium. At the same time the absence of well developed financial and monetary markets reduces the liquidity of firms²⁷ and makes the undertaking of liquid future liabilities much more risky.²⁸ Additional factors may be that “external financing makes it hard for firms to hide their activities from tax collectors or the mafia” and that “since managers have better information about their prospects than outside lenders or investors, firms must pay a premium on funds received from outside”, where “such asymmetric information problems are probably much worse in transition economies than in developed market economies, because information sources are missing and investment uncertainties are greater.”²⁹ Of particular relevance may also be the uncertainty as to the effective burden of the borrowing conditions due to the variability of inflation, which has been mentioned before, and the lack of expertise by bank officers.

3.3. *The Impact of Privatisation*

The relatively low wealth endowment of households must be added to the picture.³⁰ Privatisation processes could reduce the negative impact of this factor. In fact the relevance of distribution of state assets in increasing the propensity towards entrepreneurship has been shown by Earle and Sakova (2001, p. 29) with respect to restitution. Privatisation, however, takes essentially two forms. One is distribution of the physical assets of the previous state-owned firms, in whatever legal form (sales, leasing, theft, using for private benefit or de facto appropriating the physical assets, such as machinery, plants, buildings, in various possible ways). The other is the distribution of legal entitlements on existing firms. The first has

²⁶ Johnson, McMillan and Woodruff, 1999, p. 4.

²⁷ This means the opportunity for the owner to exit, partially or totally, from his investment without excessive delays, transaction costs and risk of capital losses in relation to a “normal value” of the firm. On the “importance of exit mechanisms to the provision of private equity financing” see OECD, 1998, pp. 78f.

²⁸ Since they can be more difficult to extend, refinance or meet through partial or total sale of the firm, according to need.

²⁹ Johnson, McMillan and Woodruff, 1999, p. 13.

³⁰ The relevance of this factor is shown empirically in the positive correlation between the propensity to become self-employed and the level of income, and thus the capability to save, in the previous period (Earle and Sakova, 2001, pp. 21, 29). Of particular importance as collateral is usually real estate. Hence the special relevance for entrepreneurship of the privatisation of the latter (see Holmström, 1996, p. 234) and the setting up of adequate public real estate recording offices and transfer procedures. From this one may understand the hindrance that the lack of privatisation of farm land (such as in Russia) can have for the development of agricultural entrepreneurship, in particular.

characterised the processes of small-scale privatisation, which usually was the earliest to be undertaken.³¹ In many cases the beneficiaries have been insiders who have used some physical assets of former state enterprises (together with their expertise) to found their own (usually small) businesses, as in the Polish processes of privatisation by liquidation. An instance of the second is Czech mass privatisation, where devolution of effective control to private owners and contestability do not really seem to have been the outcome of the wholesale distribution of formal ownership rights. The two forms of privatisation do not lead to the same kind of impact as to the development of entrepreneurship.³² Moreover in both cases much depends on the specific modalities of the processes. While increasing the scope for private entrepreneurship, privatisation reduces the scope for continued public entrepreneurship exerted by the state through hired managers. It is not immediately obvious that at the start the gains (in terms of income and employment creation) of increased private entrepreneurship as a consequence of privatisation may adequately compensate for the demise of public entrepreneurship. After all, the quality of entrepreneurship can be improved by institutional reform and better overall direction of the economy in state enterprises too.³³ If, such as may take place with mass privatisation processes, genuine prospective entrepreneurs are not favoured in relation to the general public or to insiders, if only through the selection mechanism provided by the willingness to put their own resources at risk in order to gain control, or are effectively excluded, as may be the case with foreign entrepreneurs, and ownership and control largely continue to be separated in a context where the constraints on self-dealing are weak, there is not much reason why the result should be an improvement in performance in comparison with the old socialist times, even if the whole exercise may be of some pedagogical value in learning how to manage and trade assets. In fact there are empirical inquiries that confirm the “hypothesis that what is important for company performance is post-privatisation ownership structures and corporate governance systems, rather than privatisation *per se*” (Andrejeva and Dean, 2001, p. 135). According to a “survey of 506 mid-size manufacturing firms in the Czech Republic, Hungary, and Poland conducted in the fall of 1994” by Frydman and others (1999), “privatisation is effective in enhancing revenue and productivity performance of firms that come to be controlled by outsider-owners, but produces no significant effect in firms controlled by insiders.”³⁴ It may be seen as a sign of more effective entrepreneurship in case of outside privatisation that the better performance derives from increased sales rather than reduced costs (in particular reduced employment) (*ibidem*). Both state and insider privatised firms were instead concentrating on a defensive-type of restructuring through cost and employment reduction.

³¹ For its relevance see Earle, 2000, pp. 14–15.

³² A thorough comparison of the two paths, stressing the much greater success of the Polish experience, is provided by Mc Dermott (2000).

³³ For some examples of this in the framework of China, see Krug and Hendrischke (2001).

³⁴ Frydman and others, 1999, pp. 1186–1187.

The possible negative, or less than satisfactory, consequences of some types of privatisation could be played down as being transitory since, through the working of the markets for assets and corporate control, utterly imperfect and limited in scope as they may be, non-competent owners may be eventually dispossessed in favour of more competent ones. But obviously this process is not without costs and may only work out in the long run. It would be much more preferable to bring about a better match between entrepreneurial capabilities and control through more efficient privatisation processes from the start.³⁵

3.4. *Different Types of Entrepreneurship*

Obviously the relevance of the above discussed financial and wealth constraints is strictly dependent on the nature and dimension of the enterprise. In particular they are of lesser relevance in the realm of the simplest forms of self-employment that may find their origin simply in want of better opportunities.³⁶ However this kind of self-employment in the East does not seem to be predominant (perhaps because the state sector continues to hold large quantities of surplus labour), since self-employment commands on average a positive differential (from 40% in case of Hungary up to 500% in case of Russia: Earle and Sakova, 2001, pp. 19, 40), moreover “the local unemployment rate has a negative although small effect on the entry probability, suggesting that self-employment is not (at least not systematically) a response to layoffs and lack of opportunities in paid employment” (Earle and Sakova, 2001, p. 29). Furthermore, there is a positive correlation between the propensity to enter into self-employment and the differential between the income level in self-employment and in employment (*ibidem*). Note however that the variability of earnings is much higher in the case of the self-employed (*ibidem*, p. 40). This especially applies to the case of Russia, where the standard deviation for self-employed earnings is shown to be 12 times that of wages. Moreover there are complications in assessing the data because of the possible tendency to under-reporting on the one hand, and the blending of self-employed earnings with the returns to capital investments (*ibidem*, p. 19), on the other. In the case of self-employment by professionals, the required financial and physical capital could be low, but human capital may be substantial. Note that there is an ambiguity here. A very rough measure of entrepreneurship that is often used in empirical work is the number of enterprises, assimilated to the number of the self-employed

³⁵ For an ampler consideration of these issues one can refer to Chilosi (1994). For an interesting comparison of two different privatisation processes, with diverging results, as (unintended) consequence of their institutional design, see the already quoted comparative appraisal of the Polish and Czech privatisation processes in McDermott (2000).

³⁶ Even if self-employment may be a forced choice due to want of better opportunities (“self-employment by default”), it can be an occasion for the self-employed to experiment whether they are able to run a business and a chance for the best, and luckier ones, to grow into real entrepreneurship. And certainly it involves facing the risk of a variable income (Cf. OECD, 1998, p. 142).

(for instance in the paper by Earle and Sakova quoted above). However, self-employment may be of different kinds³⁷ and it could be considered a very imperfect proxy for entrepreneurship, which is a rather different thing. For instance, a self-employed peddler could exert much less entrepreneurship in a substantial sense than a salaried manager of a large firm. Moreover one thing is to employ oneself, selling one's services, quite another is to employ other people and build a multipersonal productive organisation. There is a numerable infinity of possible sizes for entrepreneurship, as measured, say, by the number of employees, from one upward, and a continuum, if measured, say, by the capitalisation of the firm or the value of production. Taking self-employment as an indicator of entrepreneurship eliminates the huge differences between different types of entrepreneurship.³⁸ In sum, entrepreneurship is a rather elusive concept, and self-employment can be used in some circumstances as a measure of it only with many qualifications and additional information. Thus self-employment seems a rather inadequate indicator for advanced market economies, but it may not be so off the mark for transition economies, where self-employment and private entrepreneurship were severely restricted during the former regime. A simple differentiation in the set of the self-employed, which captures the difference between those who create a non-residual demand for labour following a genuine entrepreneurial choice and the self-employed, who may not present significant entrepreneurial characteristics, is between the employers ("who create jobs for others") and the own-account workers ("who work on their own or only with the support of unpaid family helpers"). The analysis of the different characteristics of the two in transitional economies forms the object of a paper by Earle and Sakova (2000), using the same data set as Earle and Sakova (2001). The conclusion is that the two groups show different characteristics and that "at least some own-account workers might prefer to be employees, but are somehow constrained (for instance because of a non-clearing market for employees) and thus are involuntarily self-employed" (p. 25). In fact "own-account workers . . . appear to be unresponsive at best, and display a negative response at worst, to their predicted earnings advantage in own-account status" (*ibidem*). Even if the real "status of the own-account workers is ambiguous", the conclusion is that "the employers are clearly genuine business owners", according to their overall characteristics (p. 2). It should be noted however that employers are only a relatively small fraction of the total of the self-employed in comparison to own-account workers: 5% vs. 15% of the workforce in Poland, from 1 to 3% vs. 6–7% in the Czech Republic, Hungary, Slovakia, and Bulgaria; less than 1% vs. 3% in Russia (*ibidem*, pp. 18 and 30).

³⁷ On the different varieties of self-employment in transition countries see OECD, 1998, pp. 275–276.

³⁸ Moreover, the extent of self-employment may depend more on the stage of development than on the effective diffusion of entrepreneurial spirit: for instance, in a small peasant society self-employment is more widespread than in a modern industrial economy (cf. Verheul et al., 2001, pp. 12–13).

A relevant question, which would be worth an enquiry, is the propensity in the conditions of transition countries for own-account workers to become more genuine entrepreneurs employing others, and for micro-firm entrepreneurs employing less than 5 employees to grow into small and medium entrepreneurs employing more. This could have some relevance for appraising the statistics concerned with self-employment and micro-firms for the growth potential of the economies concerned, as well as for policy reasons.

3.5. *Wealth and Motivation*

We have mentioned that usually entrepreneurial activities require some personal wealth (where obviously this circumstance is closely related to the nature and dimension of the enterprise). However the reverse is not true: one may well be wealthy – either by inheritance, favourable circumstances, a successful crime,³⁹ past thriftiness, accumulation of human capital and great professional abilities, cronyism and favourable political connections allowing acquisition of privatised assets at very favourable conditions, finally (why not?) because of the accumulated returns from former entrepreneurial activities – but not be willing to become or to carry on as an entrepreneur.⁴⁰ In the end, if somebody is already rich, he may simply enjoy his wealth as a rentier.⁴¹ Or at least he may not be willing to be an entrepreneur in his own country, if sufficiently more favourable conditions for entrepreneurship are perceived abroad. Thus, even if it may be much easier for wealthy people to become entrepreneurs, there is no need for them to make such a choice. In general however there may be some relationship between the level of wealth and the propensity to act as an entrepreneur, rather than as a rentier or an employee. The relationship could be positive up to some point and then

³⁹ Remember Balzac: “Behind every great fortune there is a crime”.

⁴⁰ Transition constitutes a fundamental unforeseen break in the social and economic environment of previously socialist countries. As such it provides a handy social experiment as to the determinants of entrepreneurship, since it decouples the acquisition of the characteristics affecting entrepreneurship from the decision to plan for a self-employment career (the opportunities for which as provided by transition could not have been foreseen when acquiring the characteristics to be studied). Earle and Sakova (2001; see in particular, pp. 15–16) shrewdly use this circumstance to study, in the framework of the countries in transition, the determinants of entrepreneurship (which is assimilated by them to self-employment, with some contradiction in relation to their previous conclusion, in Earle and Sakova, 2000, p. 25, that “there is a case for scepticism concerning the simple equation of self-employment with entrepreneurship”).

⁴¹ This is seemingly not understood by some Italian trade unionists and politicians when they often complain about the insufficient job creation in the South, blaming entrepreneurs. Entrepreneurs are not performing as such because of some heavenly predestination, but because of an act of choice that in principle even the blaming parties could have made. If not enough job-creating entrepreneurship is forthcoming in the South (this may apply to Eastern Europe, too), it means that the incentives (and/or the capabilities) for an adequate supply of entrepreneurship are not there. Nobody should be blamed (not even unknown potential entrepreneurial forces that do not materialise because of inadequacy of incentives) for following, in the given legal framework, one’s own inclinations and preferences.

decreasing, as in Banerji and Van Long (2001), where “under capital market imperfections due to moral hazard, the very rich and the very poor do not undertake any risk and become passive lenders”, and “only individuals whose wealth lies within medium range chose to become entrepreneurs” (p. 1), the reason being that, if “the marginal rate of substitution between effort and income is convex . . . individuals with very low wealth do not want to become entrepreneurs because they are not willing to take risks, and individuals who are very wealthy do not want to become entrepreneurs because they do not want to exert effort”.⁴² Considerations such as the above may have interesting implications for the relationship between income distribution and growth, and for that between per capita income, entrepreneurship and growth. If, by any given shape of relative distribution, a country is poor, supply of entrepreneurship may be low because of the risks involved and high aversion to risk, and the country could find itself in an underdevelopment trap, at least unless entrepreneurship is imported from abroad. If a country is wealthy the supply of entrepreneurship may be reduced because wealthy people would tend to avoid the toil and effort of entrepreneurship. It could well be that transition countries as a whole are closer to the lower end of the divide, while the growing inequality may contribute as a side effect to enhancing the supply of entrepreneurship by increasing the number of people with wealth above the lower threshold (but also the number of those above the higher one). However, the distribution of wealth does not obviously correspond to the distribution of the capabilities and attitudes towards entrepreneurship, while the financial system may be unable, especially in transition countries, because of the reasons considered above, to act as an adequate transfer mechanism from those who have command over resources to those who may have the entrepreneurial disposition to put them to productive use.

4. Constraints and Incentives to Entrepreneurship in Transition Economies

4.1. Economic and Social Hindrances

The exertion of entrepreneurship may be deterred by excessive normative and administrative obstacles to entry (licensing and others), or because the incentives towards exerting entrepreneurship at home are inadequate. Among the latter circumstances the first that may come to mind is excessive taxation of business profits. In theory, however, because of the possible contradictory responses of the income and substitution effects, increasing taxation does not necessarily lower the supply of entrepreneurship, in terms of level and intensity, neither does a decrease in taxation necessarily increase it.⁴³ It may be noted in this respect that in general

⁴² P. 16. For other related models with different sets of assumptions and results, see the literature referred to in Banerji and Van Long (2001), pp. 2–4.

⁴³ For a treatment along these lines of risk-taking see Domar and Musgrave, 1944. For a more sophisticated treatment in a general equilibrium framework, leading to the same kind of ambiguous conclusions, see Kanbur, 1979. On the general issue of the effect of taxation on the supply of entrepreneurship, see also Ilmakunas et al. (1999, pp. 5f).

the income effect may act towards limiting the size of enterprises (as entrepreneurs become wealthier they prefer to relax rather than to make the effort to bring about new advances). At the same time, as employees obtain higher wages the drive to change their status by becoming entrepreneurs may diminish, while the value of the outside option, i.e. of not becoming entrepreneurs, increases. Thus, because of the substitution effect, higher wages and decreasing inequalities may reduce the propensity to entrepreneurship, even if this should be to some extent matched by the increasing earnings from entrepreneurship in a more productive environment, if the higher wages and living standards are the outcome, as is usually the case, in the long-run at least, of the higher productivity of the economy. Therefore, both the wage share and the wage levels should be relevant in this respect. In fact, “research by Carree, Van Stel, Thurik and Wennekers (2001) suggests that the labor income share in the national income has a negative influence on the business ownership rate in 23 OECD countries”,⁴⁴ while, according to research by Ilmakunnas et al. (1999, p. 19), “a high living standard [measured as per capita GDP] may have a detrimental effect on entrepreneurship”, where the “*rate of entrepreneurship* is measured as the ratio of people working on their own account relative to the total labor force.”⁴⁵ If this were true, the latter effect should lead to a higher entrepreneurial drive in poorer transitional countries than in wealthier advanced market economies. But other kinds of circumstances may be even more important, such as those related to the social motives for becoming an entrepreneur.⁴⁶ Part of the payoff to entrepreneurship lies in the social prestige both of being an entrepreneur and, through entrepreneurship, of becoming wealthier, in the satisfaction of exerting power (that may be inversely proportional to the legal protection enjoyed by workers in the firm), and in the sense of achievement that may accompany entrepreneurial activity.⁴⁷ If an entrepreneur, instead of being subject to the rule of law, must look for the protection of politicians and local authorities, lobby them and

⁴⁴ Verheul et al. (2001), p. 27.

⁴⁵ As usual, this kind of simplistic measure casts great doubts on the significance of the result, especially in this case, where the data refer to OECD countries.

⁴⁶ For the relevance of social considerations and of the non-pecuniary aspects of entrepreneurial reward in determining the supply and nature of entrepreneurship, see, e.g., Nakagawa (1977); Casson (1995, pp. 94–95); Baumol (1990); Lydall (1992, pp. 84–85), OECD (1998, pp. 50–51).

⁴⁷ The above is consistent with the findings of Ilmakunnas and others (1999, p. 1) that “the rate of entrepreneurship is positively related to the degree of income inequality and negatively to the union power in the economy.” Legal protection may also increase the cost of labour reducing the financial returns to entrepreneurship. In particular, protection from dismissal makes the running, resizing and termination of a firm less flexible, thereby making entrepreneurship riskier and less advantageous (cf. OECD, 1998, pp. 18–19). Of course these matters are rather complicated, as some compensating factors may step in. For instance, stability of jobs could increase productivity by stimulating the accumulation of human capital, or there could be some trade-off between job stability and remuneration. However a satisfactory discussion of these issues would lead us astray. Needless to say, in this, as in other matters, the different policy objectives are usually the object of a trade-off. Similar considerations apply to the discipline of terminating a firm through bankruptcy and the protection of creditor rights (cf. *ibidem*, pp. 22–23).

bribe them together with bureaucrats, and the social prestige attached to his status is inadequate, then the psychological advantages of choosing entrepreneurship in relation to other life alternatives, such as being a rentier or an employee, may be drastically reduced. If in addition there is the danger of attracting the attention of organised crime, by being an entrepreneur as such or by getting rich through successful entrepreneurship, this constitutes an obvious additional incentive against the exertion of entrepreneurship. The above may provide some explanation for the very high rate of unemployment in Southern Italy and the reluctance of Northern entrepreneurs, even from areas where demand for labour is high, such as the North-East, to settle into the South, where they could benefit from a plentiful labour supply and somewhat lower costs of labour, but would be confronted by a worse overall environment. In this may also lie part of the reasons for the economic predicament of those transition countries where there is a crisis of legality, and the position of entrepreneurs in society is still somewhat subject to disdain, as may be the case in the successor states of the former Soviet Union. In general, in the transition countries where there is some degree of permanence of attitudes left over from the previous regime, such as may be the case in Russia, entrepreneurship may be tainted as "speculation" and entrepreneurs may be seen as exploiters, thereby reducing the social appeal of becoming one, and encouraging the temptations and social appeal of the "grabbing hand of the state", while also blurring the distinction between legitimate and illegitimate or outright criminal types of entrepreneurship. As a matter of fact Earle and Sokova (2001, p. 31) show a much lower propensity to self-employment in Russia. This could be a legacy of the attitudes of the previous system towards entrepreneurship, as well as possibly of the fact that the "homo sovieticus" was traditionally accustomed to secure and not-too-demanding jobs, leading to an adverse attitude towards risk-taking. Moreover, "a number of qualitative indices drawn up by various international organisations tell a rather consistent tale: in terms of ability for private enterprise to function free of interference and corruption, the Czech Republic is usually at the top of the list in Eastern Europe, followed closely by Poland, Hungary, and Slovakia, while Bulgaria is some distance behind, and Russia is far behind" (ibidem, p. 8). This may contribute a great deal to explaining the relative low propensity to self-employment in Russia, together with the relatively high differential in favour of the self-employed (who earn on average five times the average wage). The latter could be partly understood as a compensating differential and as a risk premium, as well as, possibly, the outcome of stronger barriers to entry. Indeed, for Johnson, McMillan and Woodruff (1999, p. 3) the existence of barriers to entry created "by a hostile business environment" explains the exceptionally high profitability of Russian enterprises. This goes hand-in-hand with an explanation of the high relative self-employment incomes, since the labour earning component is practically indistinguishable from the profit component.

4.2. *The Legacy of the Past*

Societal values and attitudes are to a great extent the products of the past history of the country, and this also applies to the circumstances affecting the supply of entrepreneurship, in its quantitative and qualitative aspects. It is obvious that countries such as Poland or Hungary or even Eastern Germany, where small private enterprise was relatively more tolerated than elsewhere, could have a greater potential of experienced entrepreneurs. A source of entrepreneurial potential may be provided in particular in those countries where direct peasant farming was maintained. On this account Poland was certainly particularly favoured, and the countries of the former Soviet Union, where direct peasant farming was ruthlessly suppressed, particularly disfavoured.⁴⁸ Moreover, the greater the span of the market, both official and unofficial, existing before transition, the greater may be considered the potential for entrepreneurship. This is reflected to some extent in actual developments and performance. It is also true that the characteristics of private entrepreneurship in the previous and present regime are rather different. During the previous regime private enterprises or genuine cooperatives, once established, were on the one hand looked at adversely and held in check by the predominant ideology reflected in actual behaviour by the authorities, but on the other could benefit from the very restrictive entry conditions, and even prosper in the interstices of the socialist system, by taking advantage of unsatisfied demand. The problem here was to adapt to the present the lessons of the past; from a setup where the ability of the entrepreneurs was to get hold of scarce supplies while benefiting from a captive market, to another where demand is scarce and competition may be fierce. Not all previous entrepreneurs have been able to adapt to the new environment.⁴⁹ Still, it is reasonable to assume that whenever there was the habit of exercising some type of entrepreneurship, be it private or public, in some kind of market environment, however limited and constrained, the experience should present a learning impact that could favour the supply and quality of entrepreneurial activity. This assumption seems to be compatible with the fact that countries such as Poland, Hungary and Slovenia, which were experiencing some form of market socialism with some tolerance for small scale private entrepreneurship, are among those that have fared the best and where private entrepreneurship has been more lively, providing a better supply response during transition than elsewhere.⁵⁰

⁴⁸ On the role of peasant farming, owing to “the traditions of self-employment and independence of the peasantry” as a source of entrepreneurship in less developed countries, see Lydall, 1992, pp. 82–83.

⁴⁹ Cf. Kolodko (1999), pp. 7–8.

⁵⁰ *Ibidem*, pp. 6–9.

4.3. *The Impact of Bureaucratic Restrictions*

Other relevant factors are bureaucratic restrictions that may create additional (and possibly artificial) barriers to entry, hampering the impact of the legal processes of liberalisation in releasing the entrepreneurial capabilities existing in the economy. Indeed, the cost (relatively to per capita GNP) and delays of setting up a business are on average much higher in transition economies than in Western democracies.⁵¹ The difference in hidden costs may be even higher, given that the extent of required administrative authorisations may be related to the degree to which bribes must be paid to the relevant authorities, and to the reach of the state's "grabbing hand". In part bureaucratic restrictions may depend on (and in some way be justified by) the imperfections in the legal system: it may be easier to influence *ex ante* the setting up of a business in order to avoid some obnoxious activities (which could for instance be damaging for public health or the environment) than to curb these activities once the business is set up (owing to the consequences on employment or the capability of established entrepreneurs to exert various kinds of leverage on the authorities). If there is effective enforcement of laws and regulations and the overall social climate is bent towards legal compliance, the need for *ex ante* administrative controls is less relevant. In the light of the above argument greater *ex ante* regulatory constraints in transition countries may have some objective justification. Indeed, decreasing regulations and bureaucratic constraints may enhance the development both of productive and of destructive entrepreneurship (where "*productive*" and "*destructive*" entrepreneurial activities" are defined as "those that increase, respectively decrease, joint surplus").⁵² One could then conceive of the existence of an optimal degree of constraints, maximising the net result of entrepreneurship (productive minus destructive). The optimal degree of constraints varies under the different circumstances, and should be higher where the propensity towards abiding by the rules is lower and *ex-post* enforcement (in particular through the courts) is more costly and difficult. On the other hand the extent of administrative formalities and authorisations may simply be an obnoxious residue, in transition countries, of a punitive mentality towards business and enterprise, with the negative consequences on the supply of entrepreneurship that have been considered above.

5. The Quality of Entrepreneurship

The disadvantage of these types of artificial constraints to entrepreneurship also lies in the adverse selection they may bring about. Instead of the entrepreneurs with the best capabilities to organise, innovate, and have a vision, the selection process favours those who are most able to get along with bureaucrats and politicians, have the right connections and the greatest capability to bribe. The quality

⁵¹ See Djankov et al., 2000.

⁵² Foss and Foss, 2000, p. 2, following Baumol (1990).

of entrepreneurship could be correspondingly impaired. Indeed, the quality of entrepreneurship, along both its dimensions, is very much affected by the overall specific environment in which transition takes place. The first dimension refers to the quality of those deciding to perform as entrepreneurs, which is influenced on the one hand by the structure of material incentives, and on the other by the economic background, cultural tradition and system of relevant social values. The second relates to the areas where entrepreneurship is exerted and to its specific characteristics. One may refer here to Baumol's (1990) distinction of entrepreneurship as "productive, unproductive, destructive". In transition countries there are many instances where "the rules of the game – the reward structure in the economy – that happen to prevail"⁵³ enhance the relative importance of unproductive or even destructive entrepreneurship. The bad shape of post-Soviet states may be associated with a tendency towards rent-seeking entrepreneurship, depending for its success on the benevolence and protection of the rulers (such as in Yeltsin's Russia) or towards straightforward destructive entrepreneurship, concerned with violent and criminal activities (such as in the case of the Russian mafia) or with the spoliation to their own advantage of the natural resources of the country (parts of the alleged activities of Russian "oligarchs", in partnership with the ruling elite). However in this case too, "it may be possible to change the rules in ways that help to offset undesired institutional influences or that supplement other influences that are taken to work in beneficial directions."⁵⁴ Indeed, institutions can and should be built or transformed in ways to favour productive forms of entrepreneurship and repress unproductive and destructive ones, even if this could be better achieved at the beginning of transition, without the obstacle provided by the pressure of entrenched interests. The whole system of institutions and regulations which are instrumental to this objective and are characterising advanced market economies, as the outcome of an evolution extending well back in time, should have been constructed. The awareness that partly at least the great disasters of transformation were due to insufficient creation and implementation of the institutions regulating and policing the market is by now widely shared, as liberalisation, and especially privatisation, preceded the effective creation of the institutions which are required for a correct functioning of a market economy.⁵⁵ In particular, the Washington Consensus, forming a conceptual policy framework for transition in the East, originally related to South America, where market economies had already been functioning for a long time.⁵⁶ The task of institution building appears not to have been adequately comprehended by foreign advisors, often utterly inexperienced with the historical and institutional specificities of the countries they were called to advise. At the same time the task of building institutions suitable for a successful market

⁵³ *Ibid.*, p. 894.

⁵⁴ Baumol, 1990, p. 919.

⁵⁵ For the Russian case, involving the consequences of mass privatisation, see Black et al. (2000).

⁵⁶ Cf. Kolodko, 1999, and the literature quoted there.

economy can be complicated by the unfettered development of criminal activities when the market (i.e. the freedom to contract) is introduced and those institutions are not yet developed. After an initial period of unfettered non-productive entrepreneurship, the non-productive economy may build lobbying activities focusing on its own protection. The outcome of the above can be an underdevelopment trap, whereby many entrepreneurial talents are directed towards non-productive forms of entrepreneurship. The damage for the economy is twofold, deriving not only from the distortion of resources (including entrepreneurial talents) from the productive economy, but also from the burden that destructive entrepreneurship imposes on productive activities. If for some reason, such as a political initiative towards better law enforcement, the structure of incentives shifts in favour of productive entrepreneurship and the size of the regular economy grows, this may reduce the relative lobbying capabilities of unproductive, rent seeking, or outright criminal, forms of entrepreneurship, possibly starting a reverse virtuous circle.⁵⁷

6. Trust and the Institutions of the Market

Parts of the relevant institutions of a market, on which both the propensity to perform as an entrepreneur and the quality of entrepreneurship depend, are informal ones, and constitute habits, routines, modes of behaviour suited to the functioning of a modern market economy (among which of particular relevance is the habit itself of abiding by the law and performing correctly in business dealings). One cannot simply assume their existence or assume away their relevance without being utterly mistaken. This applies in particular to trust (and trust as to the respect by public authorities of private property rights as well): “the most important aspect of business culture is the extent to which it promotes trust. Trust facilitates cooperation between entrepreneurs, which is just as important as competition in achieving efficiency.”⁵⁸ Indeed, trust saves transaction costs and makes possible transactions that otherwise would be impossible (implying commitments that could not easily or cheaply be validated in courts). To some extent trust is also the product of the underlying possibility of enforcing one’s legal claims: opportunistic behaviour is less worthwhile if there is always a possibility that it may lead to penalisation in the courts. Wherever the functioning of the judicial system is particularly unsatis-

⁵⁷ In Mehlum and others (2000), a development trap is derived in a model where predatory activities require a lower fixed cost than productive ones, which are characterised by increasing returns to scale. For a previous model of a development trap resulting from the interrelation of predatory and productive activities, see Murphy et al. (1993).

⁵⁸ Casson, 1995, p. 79; cf. also p. 267. See also David Hume [1739]: “The freedom and extent of human commerce depend entirely on a fidelity with regard to promises,” quoted in McMillan and Woodruff, 2000, p. 1. For an extensive discussion of the notion of trust, see Coleman, 1990, ch. 8, pp. 175–196.

factory, as is often the case in transition countries, the existence of relations of trust is both more useful and more difficult to obtain.

From this viewpoint formal institutions have a double task. The first is to favour the creation of routines. For instance, the effort towards formal enforcement of law and order, by producing internalisation of compliant modes of behaviour, may lead to a reduced need for formal enforcement. The second is the substitution of formal rules of behaviour for informal routines. Where the rules favourable to trust and trade are not the spontaneous outcome of long time interactions and past experience they can be formally established through legislation and enforced from the outside by the force of the law. Another way may be to further the kind of personal relationship and acquaintance that may facilitate the establishment of routines leading to collaboration and the avoidance of opportunistic behaviour through repeated interaction, favouring, at the same time, the transfer of information and coordination of decisions between entrepreneurs. This is of particular relevance in those transition economies that “have dysfunctional legal systems, either because the laws do not exist or because the machinery for enforcing them is inadequate,”⁵⁹ as under those circumstances relational contracting (namely contracting in the framework of a long-standing trading relationship and conditions of trust) may substitute for the lack or inadequacy of enforcement of anonymous trade relations. Relational contracting is all the more efficient as a substitute (or supplement as the case may be) for formal legal enforcement the easier is the spreading of information and the more effective are the social sanctions which are collectively inflicted on those who breach contracts and trust.⁶⁰ A formal organisation may be required in order to police the behaviour of its members, creating trust as a public good.⁶¹ Moreover, because of the public good nature of a reputation for toughness, a collective trade organisation would be ready to sue misbehaving outside contractors even when it

⁵⁹ McMillan and Woodruff, 2000, p. 2.

⁶⁰ These social sanctions may be particularly effective in case of closed tight communities such as some local communities or ethnic minority groups (cf. Mcmillan and Woodruff, 2000, pp. 16–17). This may account for the special relevance of ethnic based trust relations in the economic life of some countries (e.g. Chinese business networks in South-East Asia) and may contribute towards explaining the economic success of minority groups such as Jews or Chinese communities abroad under circumstances where effective contractual enforcement through the formal legal mechanism is defective. For other factors involved (such as those emphasised by the so-called margination theory of entrepreneurship) cf. Verheul et al., 2001, p. 16. The success of township and village enterprises in China can also be attributed to the possibility of enforcing, through community supervision and local social control, innovative contractual arrangements which otherwise could not be enforced in courts, the historical and cultural background of this being that “ever since Ming-dynasty villages and rural communities became the natural owner of natural resources (except land), the agency of last resort for civil and moral law, the basic unit of defence, and the primary collective actor in the political and social arena. Despite some attempts by Chairman Mao, this did not change much during the Mao Zedong-era” (Krug, 2000a, p. 12).

⁶¹ McMillan and Woodruff, 2000, pp. 7f.

would not pay the individual member to sue.⁶² Thus, collective private enforcement could be a complement to, rather than a substitute for public enforcement through the legal process. Similar objectives can be pursued, among others, by favouring the establishment of local enterprise networks, such as in the case of industrial districts, through joint operation by local and regional authorities and associated enterprises, as well as of trade associations.⁶³ Thus routines can arise as a substitute to formal legislation and enforcement of contracts. In this may also lie the favourable legacy of the gradual approach to liberalisation and increased scope for the market, preceding formal institutional transformation and change of regime in countries such as Poland or China.⁶⁴

On the other hand relational contracting as a substitute to legal enforcement of contracts has its own drawbacks. It increases barriers to entry and may hinder the development of younger, more efficient enterprises. To some extent this is a feature of every market where products are not standardised and the quality of contractors matters. The exclusion effect of organised private order as opposed to legal enforcement may be lower if the organisation takes place through *open* trade associations. The existence of the latter denotes a capability of society to self-organisation, but it can also be favoured as a matter of policy. On the other hand private order and relational contracting cannot completely substitute for the support that an effective legal enforcement mechanism provides for contracting (anonymous and otherwise). Moreover private order can also be involved in the organisation of criminal activities and destructive types of entrepreneurship (according to Baumol's concept), as in the paramount case of Mafia-type organisations. Forms of private organisation that arise to pursue legitimate interests, substituting for the failures of the legal framework, can turn criminal. Thus the existence of forms of private order, even legitimate ones, cannot dispense with the need to build an effective legal system.⁶⁵

7. What Can be Done

From the above some policy hints for improving supply and quality of entrepreneurship (and thus increasing sustainable employment and national income) in transition countries follow. To some extent they may be part of official policies by

⁶² Ibidem, pp. 31–32.

⁶³ One must recall however, on the negative side, the words of Adam Smith concerning the tendency of the convening of people of the same trade to result in actions for increasing and exploiting market power. This is very much of relevance in the behaviour of professional orders, which are in charge of policing their associates and enforcing standards, but at the same time are often organising collective market power on their behalf.

⁶⁴ In the latter we have a relatively long period of transition and market building, as yet without a formal change of regime. For the process of creation of routines and local enterprise networks in China see Krug and Hendrischke (2001).

⁶⁵ On the drawbacks of relational contracting, see McMillan and Woodruff, 2000, pp. 39f.

the countries concerned and assisting foreign organisations, but a comprehensive, if obviously not exhaustive, restatement can be of some pedagogical value.⁶⁶

1. Reduce the obstacles to efficient flow of investable funds towards financing existing and incoming enterprises. This can be implemented by making the working of the financial and banking systems more competitive and transparent and creating the needed institutional infrastructures. This would provide better opportunities for the internal use of savings, reducing the tendency for capital to be exported. In transition countries this tendency can be considered to some extent as physiological. In a context in which in the previous system individuals did not usually own assets abroad (especially in countries that were relatively closed to the outside world), even if they maintained internally some, sometimes substantial, balances in foreign currency, the decision to acquire some assets abroad may be an understandable move of portfolio readjustment, which could be compensated by the influx, for symmetric reasons, of foreign funds to the country. However outflows can also be the outcome of a climate of uncertainty, of lack of law and order, insufficient protection of property rights, and variability of real returns owing to a high and unpredictable inflationary environment, and lack of reasonably safe financial outlets internally. Once these factors are removed, the net inflow of foreign resources can be quite substantial, as is borne out in the paramount Polish case after 1994 (when the main blocking factor, the unsettled position of foreign indebtedness, was overcome). In the opposite paramount case of Russia, on the other hand, capital exports have been, and continue to be, quite substantial. According to a recent report (RFE/RL 2001), "World Bank experts have concluded that approximately \$10 billion of capital flight occurred during the first six months of 2001 . . . Bank officials said the situation is 'paradoxical' because Russia needs investments but lacks the financial arrangements that are needed for Russian firms to invest at home."
2. Some publicly supported guarantee funds for (limited) financial assistance to new entrepreneurial initiatives (particularly by younger entrepreneurs) deprived of adequate collateral may be crucial for discovering valuable entrepreneurial talents which could otherwise never manifest themselves. In some OECD studies young people declare a relatively greater propensity for self-employment, but the probability of starting a business is greater for higher age groups. The explanation lies in the relatively greater lack of collateral and own resources of younger workers.⁶⁷ There is obviously scope to intervene here correcting what could be seen as a distortion, since it is of general interest for entrepreneurial talents to be offered the opportunity to develop from an early age. Another distortion that could be cured by interventions of this sort is the

⁶⁶ Cf. also the "broad policy guidelines" for fostering entrepreneurship in OECD, 1998, pp. 28–30, and Commission of the European Communities, 2001.

⁶⁷ Cf. Verheul et al., 2001, p. 32.

tendency for commercial loans to favour those with the best guarantees rather than with the best projects. Obviously a balance should be struck between the results obtained through favouring the emergence of entrepreneurship and the opportunity cost of the scarce financial resources that are involved, the crucial factor being here the default rate. In the case, as in some schemes, the beneficiaries of subsidised credit for starting a business are the unemployed, the overall opportunity cost both of finance and entrepreneurship is lower because of the need to support the unemployed on the one hand, and the lack of alternative occupation for the unemployed, on the other.⁶⁸ However it is not obvious that this would really be an advantageous option because being unemployed is not evidence of entrepreneurial capabilities.⁶⁹ Some analogous considerations as to the publicly supported guarantee funds apply to mutual guarantee funds. The latter may help to overcome the barriers to small entrepreneurship caused by lack of collateral and high administrative costs involved in assessing the prospects of those who borrow relatively small sums. The screening of applications for guarantees may be entrusted to the representatives of mutual guarantors who in their decision could take advantage of private information not available to the bank, but available to those, belonging to the same entrepreneurial milieu, who are involved in the fund. The incentives in favour of repayment operate through social control, and part of the administrative costs of assessment and enforcement are saved.⁷⁰ As a matter of principle no public intervention should be needed, since the mutual fund could be self-supporting and operational costs could be covered by fees paid by the applicants. In practice some kind of public help (with the possible enlisting of foreign donors) for establishing the fund and offsetting transaction costs could be justified by the market failure deriving from asymmetric information and the usual free-rider problem blocking positive social action, and by the opportunity for creating valuable network effects (see below point 7).

3. Increase the supply of potential entrepreneurs by increasing the resources in those areas of education that are especially useful for the formation of new entrepreneurial capabilities. However, to determine what areas of education are the most conducive to the development of entrepreneurial capabilities may be not an easy task, aside from the obvious consideration that the teaching of

⁶⁸ A straightforward scheme of this sort is to continue to pay the unemployment subsidy for a certain period after the start of a self-employment activity (cf. OECD, 1998, p. 158).

⁶⁹ However, according to OECD (1998, p. 25) "these programmes have proven to be a cost-effective alternative to income support". Moreover, there is some basic merit in policies that lead to an increase of genuine entrepreneurship in areas of economic decline and unemployment, as an alternative to passive policies of income support or to policies trying to combat unemployment through outright subsidies to declining industries or even to policies of attracting new initiatives through public subsidies, with controversial overall results (ibid., p. 108).

⁷⁰ Cf. OECD, 1998, p. 99. For two interesting Polish case studies see Woodward, 2001, pp. 1016–1017.

the basic technical skills and notions needed to running a business, such as accounting, marketing or commercial law, should be made readily available to anybody willing to start an entrepreneurial activity.⁷¹ Otherwise it is not obvious what kind of curriculum provides a better preparation for entrepreneurship, unlike for becoming, say, a medical doctor, an engineer, or a teacher of Greek.⁷² Moreover it is not necessarily better-educated people who make more willing and able entrepreneurs. According to Leibenstein, “some types of higher education provided to potential entrepreneurs may be dysfunctional in that it increases the opportunity costs of potential entrepreneurs and may as a consequence decrease the supply of entrepreneurship.”⁷³ As far as transitional countries are concerned, a negative relationship between enterprise growth and education level of entrepreneurs is shown in the data reported by Bartlett and Bukvić (2001, p. 199). However Anderson and Pomfret (2001, pp. 2332–2333) report a positive relationship between educational level and business start-ups. Earle and Sakova (2001, pp. 2, 26) find a positive relationship between education and entrepreneurship (or to be more exact, self-employment) in six transitional countries, but a lower return to years of schooling for the self-employed than for the employees (returns that in both cases are at any rate relatively small: *ibidem*, p. 23). Obviously some kind of basic education is required to start and run a business, but sometimes it could be of greater importance for successful entrepreneurship to have thorough practical expertise in some specific branch of production, together with an intelligent mind and a propensity for risk taking, rather than long years of formal teaching far from real life experience.⁷⁴ An alternative point of view is that education, any kind of it, could bring about, other things being equal, better intellectual capabilities, which can be useful for starting and running an enterprise. In this respect one may expect that the relatively high educational attainments under the previous regime would have a favourable impact on the supply of entrepreneurship. Earle and Sakova (2001, pp. 26–27) demonstrate that this factor has some relevance even through the filter of family environment, by showing a strong correlation between the propensity to self-employment and parental educational attainments, in a context where the latter are not necessarily associated with substantially more savings and wealth.

⁷¹ For a short general discussion of the relationship between education and experience, with several bibliographical references, see Verheul et al., 2001, p. 34. See also Binks and Vale (1990), pp. 131f.

⁷² Cf. Verheul et al., 2001, p. 34: “Whether and to what degree entrepreneurial qualities can be taught is a subject of debate in entrepreneurial literature”. According to OECD (1998, p. 35) “the effects of education on entrepreneurship have not been fully examined. Whether and how national *curricula* might be modified, which age groups should be targeted and how widespread might be the impact of educational initiatives are all issues in need of greater assessment.” Cf. also *ibid.*, pp. 87–90.

⁷³ Leibenstein, 1968, p. 8. For some remarks on the issue along similar lines see Casson (1995, p. 95).

⁷⁴ Cf. Lydall, 1992, pp. 24–25.

4. Improve the overall legal climate, subjecting all entrepreneurs, equally, to the rule of law and safeguarding their property rights. As exemplified by Baumol's (1990) historical discourse, arbitrariness of power and lack of legal protection can be highly damaging to the effective exertion of entrepreneurship.⁷⁵
5. Encourage the influx of foreign entrepreneurship by giving safe conditions to foreign entrepreneurial initiatives, putting them on an equal footing with those of local entrepreneurs. The scope for the influx of foreign entrepreneurship during transition is obviously related to the privatisation methods pursued. For instance, "the direct sale method . . . giving equal access to all bidders, including foreign investors" chosen by Hungary as the main privatisation method has been favourable to the import of foreign entrepreneurship and has "resulted in efficient restructuring".⁷⁶ As a consequence the relative importance of FDI (Foreign Direct Investments) is in Hungary by far the highest among CEEC countries.⁷⁷ Often the influx of foreign entrepreneurs is seen critically in nationalistic environments, such as those of many transition countries. However there seems to be hardly any serious reason to favour domestic over foreign entrepreneurship. Foreign entrepreneurship may lead to positive spillovers as far as technological advance, training and change in business culture are concerned.⁷⁸ The only lasting relative disadvantage of foreign entrepreneurs may be their possible greater propensity to export profits. But they may also have a greater propensity to import capital and technology. Moreover, in a political economy perspective, it is less politically defensible to subsidise a foreign rather than a domestic enterprise, and this may make future wastage of scarce financial resources through subsidisation of loss-making firms less probable. The perspective may be somewhat different if the objectives and constraints of the foreign company are qualitatively different from those of ordinary enterprises and related to some foreign non-entrepreneurial interest such as may be the case if the foreign company is state-owned,⁷⁹ or if the opportunities for the foreign company to take advantage of market power are higher than for domestic enterprises. But the latter case refers to the more general issue of antimonopolistic controls, rather than to the issue of foreign vs. domestic ownership as such.

⁷⁵ In particular, according to Baumol (1990) this factor furnishes an explanation (together with the adverse social values) for the lack of industrial development of medieval China, notwithstanding its superior civilisation and technological knowledge (pp. 901–903, 911–912).

⁷⁶ Mickiewicz et al., 2001, p. 223.

⁷⁷ *Ibidem*, p. 1136.

⁷⁸ *Ibidem*, p. 1135. For a more articulated view pointing to some possible negative (if only transitory) consequences of FDI on the employment structure of transition countries due to the distorted wage structure see *ibidem*, p. 1149: in particular, FDI firms may hire highly skilled workers from state firms for tasks requiring inferior skills, resulting in misallocation of labour.

⁷⁹ As alleged in the case of the recent investment of the French state-owned energy monopolist in the Italian ENEL.

6. Eliminate artificial barriers to entry (such as many types of licensing and registration requirements) that exist for protecting the interests of incumbents and fostering the power of politicians and bureaucrats.⁸⁰ In theory they could perform some useful function such as limiting the waste associated with excessive entry under imperfectly competitive conditions. But the chance that such measures could be excessively restrictive is overwhelming. The usual controls associated with overall safety and competence standards should remain, but should not lead to artificial restrictions to entry, even if this in practice may be difficult to uphold. The tendency, nowadays popular in the West, towards setting up a single registration office, following the example of the French *Centre de Formalités d' Entreprises*, where all the required formalities for the establishment of a new enterprise could be jointly performed, is worth imitating.⁸¹
7. Encourage collaboration and organised exchange of information among entrepreneurs and between entrepreneurs and local authorities,⁸² with the possible aim of coordinating public and private initiatives, stimulating fruitful interchanges that lead to more effective entrepreneurship and to the development of social capital,⁸³ by favouring the creation of relationships of trust and personal acquaintance. The latter may facilitate fruitful business relations because of the greater informational content provided by personal contacts. Promote the development of material and immaterial local infrastructure (along the lines of the more successful cases of the *Associational Economy*; see Cooke and Morgan, 1998) leading to crucial external economies favouring the creation of clusters.⁸⁴ The latter, in their turn, may lower the barrier to entry by allowing

⁸⁰ It is interesting to note the great variability of time and procedures for registering a firm. There is some good point for transition countries to strive hard to imitate those countries such as Germany where "about 1 day is required to register an unlimited company", rather than Italy, where "it can take over 20 weeks" (OECD, 1998, p. 54). For the "notoriously bureaucratic and lengthy" "registration procedures for newly created firms . . . in the countries of central and eastern Europe", see OECD, 1998, p. 280.

⁸¹ See OECD, 1998, p. 54.

⁸² Indeed, "many important programmes to support entrepreneurship", such as "business incubators, advisory and information services, loan guarantee consortia", "are best designed and implemented by local authorities" (OECD, 1998, p. 26).

⁸³ "The complex of institutions, customs and relationships of trust conducive to cooperation" (OECD, 1998, p. 96). On social capital cf. Coleman, 1990, ch. 12, pp. 300–321.

⁸⁴ The importance of this type of intervention is stressed by Woodward (2001). He regards its insufficient pursuit in Poland as responsible for the unsatisfactory experience with other kinds of interventions of the sort that have been advocated above for promoting entrepreneurship. For the importance of creating business networks for SME (small and medium enterprises) in the overall framework of policy measures in favour of SME, with some caution about their real efficacy, see Bartlett and Franičević (2001). The importance of the continuance of private-public networks, as inherited from the previous system, for the overall economic results of economic transformation is stressed in McDermott (2000). In some cases, such as in the Chinese one of township and village enterprises, collaboration between private entrepreneurs and local authorities is pushed to the point of configuring successful forms of joint entrepreneurship (see Krug, 2000b).

“individual entrepreneurs to start firms which concentrate on only a small part of a given industry.”⁸⁵ Contributing to the setting up of some types of collective organisations may be justified by the external economies that are created by the founders to the benefit of later participants.⁸⁶ Public investment in the spreading of relevant business information, such as public business advice centres, can be also justified by information being a public good and by the contribution it can make to the reduction of the barriers for new entrants.⁸⁷ Analogous considerations refer to quality certification organisations.

8. Avoid mindless subsidies leading to the *Mezzogiorno* syndrome, whereby short-lived initiatives are stimulated by the aim of grabbing subsidies, without effective long lasting consequences, or with unsatisfactory productive and employment results. One thing is the provision of public goods and services and the catalysing effect of public (especially local) authorities in stimulating local initiatives and the creation of enterprise networks, another is the distortionary distribution of subsidies, which, especially if they are discretionary, may lead to the development of political (in the sense of specialising in lobbying political authorities for protection and subsidies) rather than genuine entrepreneurship.
9. Wage rate increases should be held in check.⁸⁸
10. Combat corruption and make tax rates and regulations reasonable. Do not compel business to avoid taxes and to corrupt tax officers simply to keep running because of prohibitive tax rates.⁸⁹
11. Finally, the quality of any policy measure is strictly related to the quality of the public authorities effecting or organising it. An obvious example is how the profound corruption of the Russian government has ruined the privatisation process in Russia, whatever the theoretically assumed intrinsic merits and the alleged good intentions of its proponents, with a lasting toll on the quality of capital governance and the efficiency of the Russian economy. In a nutshell, the quality of public life and the ways in which state enterprises were privatised led to a situation characterised by the fact that “self-dealing was easy, running a business for profit was hard, growth prospects were dim, voucher privatisation separated control from cash flow rights, controllers’ time horizons were short, capital markets were rudimentary, managerial skill was

⁸⁵ OECD, 1998, p. 93. Even if “most clusters . . . have not occurred as an outcome of public policy” and “it is . . . probably unwise for policymakers to attempt to create clusters”, since “the clustering of firms has complex determinants, which greatly constrains effective policymaking” and “there are numerous possible sources of inefficiency in such a course of action” (ibid., p. 95), the kind of measures envisaged here should do no harm.

⁸⁶ For a similar argument relating to the creation of mutual guarantee consortia, see OECD, 1998, p. 99.

⁸⁷ Cf. ibid., p. 185.

⁸⁸ See above, sect. 4.

⁸⁹ The dire consequences of corruption associated with excessive theoretical tax rates in the Russian case are well described in Black et al., 2000, pp. 30–31.

scarce, unprofitable firms were subsidised while profitable ones were heavily taxed, and many businesses were sold to crooks who were predisposed to self-dealing".⁹⁰ Thus the improvement of the quality of political life and public administration should be in any case be high on the agenda. Of particular relevance here is the quality of the local authorities in ensuring a suitable environment for private initiative, through concern for its needs and adequate provision of public goods. Among the latter, of particular importance is trust arising from predictability and equanimity of behaviour.⁹¹ The creation of the institutions that favour the productive exertion of entrepreneurship (such as commercial law, bankruptcy law, the law of contracts, antitrust, bank supervision, a Security and Exchange Commission, an independent and effective judiciary, in short the enforcement of law and order in the market and outside the market) should be effectively pursued, even if their actual implementation may require much administrative effort and, in particular, time, because of the constraints provided by the learning process. Here again, the countries where the learning process started earlier and the memory of market institutions was not so far removed in time as to have completely faded away have been obviously favoured. One should consider that the basic institutions of modern capitalism, such as the banking system or the joint stock company, intrinsically imply the management by somebody of somebody else's assets and money. There is no escape from the need to establish institutions for controlling that this management takes place without foul play and to punish the offenders. If the policing is not credible the functioning of a private market economy ('capitalism') may be greatly impaired. (This obviously applies to socialism too, with respect to state property, as is borne out by the experience of the last period of socialist regimes.) Thus one of the most important tasks of transformation is to ensure, through adequate policing and control and the introduction of the appropriate institutions, that people administering somebody else's wealth (including the wealth which belongs to the state) are prevented from stealing it in one form or another.⁹²

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⁹⁰ Black et al., 2000, pp. 38–39. The paper is an impressive indictment of the way transition in Russian was run, and makes most interesting reading.

⁹¹ The nature of local authorities' behaviour has been crucial in such successful developments as the creation of industrial districts in Emilia Romagna or the townships and village enterprises in China. On the latter point see Krug (2000b).

⁹² Cf. Chilosi, 1994, p. 29.

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