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ENTREPRENEURSHIP AND PRIVATIZATION IN CENTRAL EUROPE: THE TENUOUS BALANCE BETWEEN DESTRUCTION AND CREATION

ANDREW SPICER
University of California at Riverside

GERALD A. MCDERMOTT
BRUCE KOGUT
University of Pennsylvania

What is the best set of privatization policies to release entrepreneurial endeavors in transition economies? Policies of mass privatization in Central Europe were predicated on the belief that private ownership through securitization of property rights would provide powerful incentives for efficient restructuring. In retrospect, the more radical privatization programs not only failed to achieve the expected restructuring but also hindered the development of entrepreneurial activities. In this article we develop four propositions, arguing that entrepreneurship is better fostered through gradualist policies permitting negotiated solutions to restructuring, as opposed to market-driven reforms.

The collapse of communism in the socialist bloc posed a fundamental entrepreneurial problem: how should the assets and liabilities of the state-owned enterprises be restructured in the context of rapid reform to market capitalism? The initial policy consensus was that a policy of rapid mass privatization was needed to revitalize the state sector. In Russia over 15,000 large and medium companies were privatized in a period of only 2 years. In the Czech Republic over 1,800 companies were privatized in less than 4 years. Between 1991 and 1996, fourteen countries adopted mass privatization programs, leading to a combined total of over 30,000 medium- and large-size companies privatized through this manner (Lieberman, 1997). Mass privatization policies have led to one of the most revolutionary transfers of public property to private hands in modern times.

Despite the initial enthusiasm for mass privatization policies, a new discussion over the efficacy of such a radical program of institutional reform has emerged. The new debate has arisen because mass privatization has not led to thors have called for a re-examination of the theoretical underpinnings of policies of rapid mass privatization (Ellerman, 1998; Pistor & Spicer, 1997; Stiglitz, 1999).

In this article we contribute to the growing debate over the efficacy of mass privatization programs by examining the institutional foundations of privatization theories. We first review theories by which scholars advocated the importance of speed in implementing mass privatization. The justification of a policy of rapid mass privatization policy is based on a vision of entrepreneurship that suggests that the benefits to a market economy can be created quickly once the power of the state to control economic activity is removed. Advocates of rapid mass privatization theorized that the "depoliticized" market would quickly fill the void left by the rapid destruction of the state planning system (Boycko, Shleifer, & Vishny, 1995; Shleifer & Vishny, 1994). They argued that once private ownership rights were delineated and the state cut off from economic activity, market incentives would be sufficient to improve corporate governance and reerty reform in postcommunist economies might lead to better entrepreneurial outcomes than a policy of rapid mass privatization. Informing our analysis is a core insight of institutional theories across multiple disciplines: social and economic patterns and outcomes are not produced solely by the aggregation of individual behavior but also by the collective rules, norms, and beliefs that structure action (Clemens & Cook, 1999). From this perspective, the outcomes of private economic activity are closely tied to the social organization of the broader environment in which this activity takes place (Acs & Audretsch, 1993). This viewpoint suggests that the success of market systems in coordinating economic activity toward productive activity depends on more than the presence of individual actors exploiting opportunities in a "depoliticized" environment. Instead, entrepreneurial behavior is viewed as inextricably embedded in the broader sociopolitical environment in which competition takes place (Evans, 1995; Granovetter, 1985; North, 1990).

Advocates of rapid mass privatization emphasized the need to destroy old institutions rapidly in order to create new markets quickly. In contrast, we stress the challenges involved in developing new institutions to coordinate and control economic activity. Advocates of "shock therapy" called for the introduction of a series of reforms designed to destroy the central planning apparatus of the Soviet system rapidly so that a new decentralized economy coordinated through market prices and competition could develop quickly (Aslund, 1992, 1995; Sachs, 1993). Those holding the alternative, gradualist view of economic transformation in postcommunist countries admitted the necessity of market reforms but argued for the slower destruction of the communist system to allow for experimentation and learning in the evolutionary formation of a new economic system (Grabher & Stark, 1997; McDermott, 1998; Murrell, 1992; Stark, 1996).

The benefits of speed over gradualism won the initial policy debates over reform in East Central Europe. In a 1995 speech, Michel Camdessus, then the director of the International Monetary Fund (IMF), summarized the accepted wisdom of reform in postcommunist economies:

> First, and most important, the most appropriate course of action is to adopt a bold strategy. Many countries, including countries of the former Soviet Union, have by now proven the feasibility of implementing policies of *rapid*—and I stress rapid—liberalization, stabilization, and structural

their voucher in a particular company.[1] At the end of the mass privatization process, firms are joint-stock companies whose new shareholders hold legal rights to engage in active corporate governance and to receive a portion of the firm's profits through dividends.

Advocates of mass privatization emphasize that an important benefit to the market-based nature of mass privatization procedures is that it allows market reformers to introduce radical privatization rapidly, before potential opposition to such a program can be organized (Boycko et al., 1995). The voucher auction system avoids the potentially lengthy and costly valuation procedures that accompany traditional investment banking models of privatization through cash auctions. Moreover, the supervision of voucher auctions often can be implemented within new and temporary state bureaucracies that owe allegiance to market reformers advocating mass privatization and that can be legally insulated from other interest groups.

The theoretical justification for mass privatization, however, rests not only on the speed with which the Soviet state can be destroyed through this privatization procedure but also on the argument that private entrepreneurship itself will quickly develop to fill the void left by the rapid destruction of the previous system. Through the transformation of property rights into the form of tradable securities, mass privatization policy is deliberately designed to allow for secondary market trading in property rights to facilitate consolidation of shares in the post-privatization environment. In describing the ability of the market itself to redefine the property relations between the multiple claimants to state-owned enterprises, Shleifer and Vishny write that "[mass] privatization is a way to define the property rights between these various claimants so that efficient bargains could subsequently be struck" (1994: 139). Their argument is that the market opportunities for "efficient bargains" that mass privatization creates will lead to the eventual consolidation of shares by strategic investors willing to engage in enterprise restructuring. Arbitrage, thus, is not only a means by which markets are perfected but should also lead to the consolidation of shares in the hands of owners who value them the most.

Despite the initial policy consensus of the importance of rapid mass privatization in postcommunist economies, the evaluation of privatization policy based on its speed of implementation recently has been challenged. Nellis (1998) points out that those countries that have implemented rapid programs of mass privatization show no signs of better economic performance than countries that have undertaken a more gradual reform path. Other authors have challenged the argument of the importance of speed in privatization through a comparison of the Russian and Chinese cases (Burawoy, 1996; Stiglitz, 1999). Although Russia implemented a mass privatization program that privatized thousands of companies in a period of a few years, its economy has suffered depression-level rates of development. In contrast, China's rapid pace of economic growth has taken place in the absence of a formal privatization program.

Sachs and Woo (1997) argue that it is differences in initial economic and political conditions, not policy choices, that explain the differences in Russian and Chinese economic development. They suggest that the agricultural roots of the Chinese economy, combined with the decentralized nature of political control, allowed for different options of reform in China that were not available in Russia. Their argument highlights the inherent "small-n" problem of using comparative cases in trying to link policy choices to macroeconomic outcomes. Given the small numbers of countries that have adopted the different models of economic reform, it is difficult to control for variance in initial conditions in tracking the long-term effects of policy choices.

One method to overcome the inherent limitations of comparative analysis is to examine additional cases that support or contradict patterns of relationships found in other contexts (Ragin, 1987). We suggest that the reform experiences of the Central European countries of the Czech Republic, Hungary, and Poland provide an important set of cases by which to further understanding of the relationship between policy choices and long-term entrepreneurial outcomes in postcommunist economies.

[1] An analogy can be made to the system some business schools use for allocating space in elective courses and interviews. Students are given a certain number of "points," which they can bid in differing degrees for certain desired spots. Final allocation is based on market-clearing outcomes, which are based on the total number of points bid.

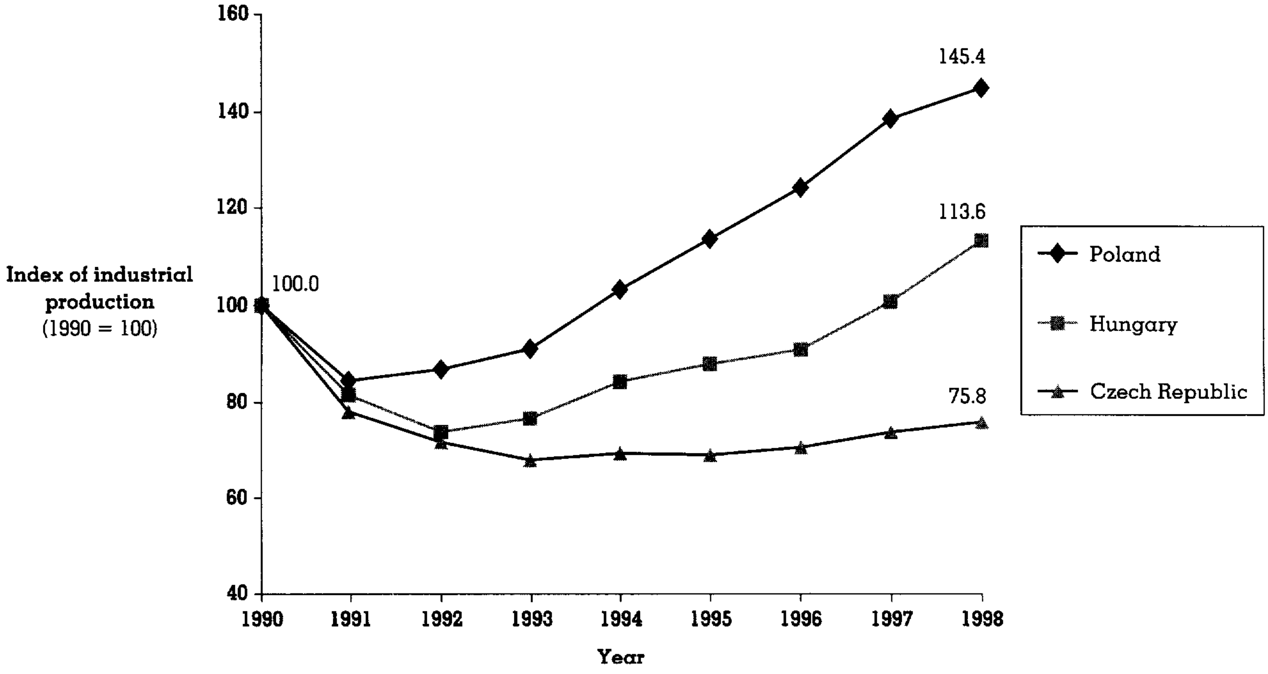
Mass privatization in the Czech Republic often is considered a model of the successful implementation of a rapid privatization program (see Boycko et al., 1995: 82–83, and World Bank, 1997: 6). In contrast, Hungary and Poland undertook a more gradual course of reform, which we identify as "negotiated property rights reform." In Hungary the gradual transformation of property relations during the early 1990s involved the restructuring of collective assets and liabilities inherent in the networks of relations developed during the socialist era (Stark, 1996). In Poland bank-led restructuring and enterprise leasing programs have brought about a recombination of the existing assets of the socialist system into new forms of property relations (Gray & Holle, 1996; Levitas, 1994).

Our distinction between the concepts of privatization and property rights reform to describe reform efforts in Central Europe is based on a similar distinction used by Walder (1994) in his analysis of property rights transformation in China. Walder defines *privatization* as the creation of clear and legally enforceable property rights of firms versus the state and *property rights reform* as the clarification and reassignment of ownership rights among multiple economic actors, whether they are government agencies, public or private corporations, households, or individuals (1994: 53). He suggests that property rights reform in China has taken place through informal mechanisms of negotiation and compromise that often leave significant ownership control in the hands of governmental jurisdictions and agencies, instead of through a formal privatization program characterized by the direct transfer of property from the state to private owners. Our use of the term *negotiated property rights reform* to describe transformation processes in Hungary and Poland emphasizes the similar use of informal negotiation and bargaining on a case-by-case basis in determining how new property rights are to be reassigned in these countries.

An examination of macroeconomic performance of the Czech Republic, Hungary, and Poland shows relatively similar performance of GDP growth and industrial output in the first half of the 1990s. However, Hungary and Poland, despite their slower efforts at property reform, have been performing better on a number of variables since the mid 1990s.

As illustrated in Figure 1, industrial restructuring in the Czech Republic barely has risen

FIGURE 1
Industrial Production in the Czech Republic, Hungary, and Poland



Source: OECD (1999).

over time, as of yet not reaching the previous levels of 1990. The Czech Republic's failure to restructure is particularly striking compared to the steady growth of industrial output in both Poland and Hungary since 1995 (Organization for Economic Cooperation and Development [OECD], 1999). These large differences in the pace of industrial restructuring recently have become reflected in GDP growth. In 1998 GDP in the Czech Republic contracted by 3 percent, in contrast to a 5 percent expansion in Poland and Hungary (*Business Central Europe*, 1999).

These macroeconomic data suggest the following proposition, the theoretical roots of which we examine in more detail throughout the rest of the article.

> *Proposition 1: Policies of negotiated property rights reform in postcommunist economies lead to more industrial restructuring than do policies of rapid mass privatization.*

This proposition is commensurate with the macroeconomic data comparing the Czech Republic, Poland, and Hungary, as well as the data comparing China and Russia. However, it is difficult to identify a direct linkage between privatization policy and long-term economic growth both solely on an analysis of macroeconomic variables (United Nations Conference on Trade and Development [UNCTAD], 1995: Chapter 7).

In the following sections we develop microinstitutional explanations that support the proposition that mass privatization leads to less industrial restructuring than more gradualist procedures. The theoretical propositions are derived from an institutional perspective on post-privatization entrepreneurship that challenges the initial acceptance of the need for speed in implementing large-scale privatization programs. We use microinstitutional details of the processes and outcomes of property reform in the Czech Republic, Hungary, and Poland to illustrate the underlying dynamics of the propositions in practice. The theoretical analysis, as well as the case illustrations, provides complementary support for the argument that the macroeconomic results in the comparison of Hungary, Poland, and the Czech Republic at least partially arise from the different types of privatization policies undertaken.

AN INSTITUTIONAL PERSPECTIVE ON PRIVATIZATION AND ENTREPRENEURSHIP

The vision of entrepreneurship that supports the importance of speed in mass privatization theory is based, however incompletely, upon a view of markets as consisting of individual agents pursuing self-interest coordinated solely through price and competition. The institutional context of reform in particular countries or localities is delegated a secondary role in the choice of policy options. The universal nature of decentralized market exchange to achieve optimal economic outcomes is perceived to be more important "than a country's starting conditions, natural resources, or external assistance" (Camdessus, 1995).

Kirzner's (1973) definition of entrepreneurship as the exploitation of the information that prices convey fits the underlying logic of the market perspective present in rapid mass privatization theory. Kirzner posits that entrepreneurs "discover where buyers have been paying too much and where sellers have been receiving too little and bridge the gap by offering to buy for a little more and to sell for a little less" (1973: 41). This perspective has a current echo in the resource-based view of the firm. Firms converge to common (and better) capabilities to the extent that information regarding the value of assets is public and strategic factors (e.g., management) can be purchased in the market (Barney, 1986). Mass privatization reforms endorse this observation as an operative principle of market capitalism. It is through information regarding value, the incentivized effort of managers, and prices that economic development is initiated.

This vision of the market as a global force of convergence to optimal institutions and the entrepreneur as the trader who perfects these markets through arbitrage and exchange ignores broader theoretical literature on the importance of institutions in explaining entrepreneurial outcomes and processes. In contrast, like others who emphasize the importance of country effects on privatization outcomes (Lopez-Calva, 1998), we begin our analysis with the premise that privatization efforts in former socialist economies need to be examined within the particular economic and institutional contexts faced in these economies. This requires moving beyond the study of privatization outcomes solely at the level of the individual firm, in order to include an examination of how privatization policy influences and is influenced by the social organization of economic coordination and control in the broader institutional environment. In the following sections we move beyond the level of the firm to examine the effect of privatization in postcommunist economies on (1) the formation of capital markets, (2) the reorganization of network ties, and (3) processes of long-term institutional change.

Privatization and Capital Markets

One important contribution to an institutional perspective on entrepreneurship is the work of Douglas North and his colleagues (North, 1981, 1990; North & Thomas, 1973; see also Eggertsson, 1990). This institutional economic account relies on the concept of "market imperfections" to explain why the incentives for individual profit-seeking behavior in the price-making market often diverge from the most productive use of economic assets. One type of market imperfection arises when property rights to a good or property do not completely incorporate the full costs or rewards to the individual owner. In these activities profit-seeking behavior of private actors might have "externalities" for other actors that are not fully encompassed in the underlying price of the sale of goods.

A second type of market imperfection arises from the high costs of transactions through the price-making market. In this case, even if property rights are properly aligned, the underlying costs of engaging in exchange might lead to the misalignment between individual profit and economic efficiency. The possibility for opportunism in precontractual negotiation or postcontractual fulfillment of contracts allows for profit-seeking agents to exploit conditions of economic exchange at the expense of other stakeholders involved in exchange.

North and Thomas (1973) and North (1981) argue that Western economic development was based on the ability of institutional "rules of the game" to constrain and structure the activities of the entrepreneurs who competed under those rules. The misalignment between the private incentives of economic agents and the collective goal of economic development brought forth the need for institutional rules to constrain the behavior of private entrepreneurs. Instead of suggesting that institutions converge on an idealized set of market-efficient practices, however, North (1990) argues that institutional rules develop upon path-dependent projectories that reflect differences in local environments. One important source of path dependency in institutional change is that private actors might benefit more from exploiting present opportunities for short-term profit under an existing institutional system than from engaging in long-term efforts at building new institutions that might be more productive for the economy as a whole. In the absence of an effective set of institutions, North suggests that private self-maximizing behavior will often "favor activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them" (1990: 9).

North's (1990) equation of institutions to the rules of the game leads to a different interpretation of the impact of mass privatization on the formation of new markets than does the initial theory supporting a policy of rapid privatization. Mass privatization of state-owned companies rapidly creates new private organizations. Yet, the speed and scale with which mass privatization is undertaken allow for little time, effort, or resources to be devoted to constructing new collective market institutions. Thousands of newly privatized entities are placed into the marketplace before new institutional rules and procedures are created to coordinate and control these new private actors.

The introduction of private competition before complementary market institutions through mass privatization policy is particularly apparent in the formation of new capital markets. Mass privatization creates not only thousands of new privatized companies but also a large number of investment funds, stockbrokers, and bankers, who enter the market to exploit the opportunities for financial intermediation in the postprivatization environment. The question of whether these new actors develop a new securities market to facilitate exchange is an important question in the evaluation of mass privatization policy. A major justification for the speed of mass privatization is that secondary market exchange of property rights will lead to the eventual consolidation of ownership in the hands of those who value the shares the most.

The lack of complementary institutions to oversee and regulate security markets, however, is striking in the postprivatization period. Mass privatization creates the opportunities for market exchange, but within a context with no established judiciary or enforcement system to monitor and enforce the fulfillment of market contracts. It creates the conditions for investment in private ownership, but within a context with no established bankruptcy procedure designed to mediate between multiple stakeholders in the case of failure. It creates the possibility for corporate governance by private actors, but within a context with no established accounting or auditing mechanisms to provide credible information to new owners.

Moreover, the deliberate bypassing of the state in mass privatization policy leads to the situation in which private competition is developed before new political mechanisms of deliberation and conflict mediation can be developed. Not only are the formal institutional rules relatively undefined but there is no established political mechanisms by which to create, monitor, or enforce new rules, if such a need were to arise. For instance, even if bankruptcy procedures become desired among some market participants, it is unclear who would lead this process in a fair and open manner.

The presence of widespread market imperfections in capital markets has led some economists to warn of the difficulties of unregulated private activity in this sector of the economy in any context (Stiglitz, 1994). The particularly weak institutional constraints over private activity in the aftermath of a rapid mass privatization in postcommunist countries only enhance the problems of exchange in large-scale capital markets. The opportunities for short-term profits from financial market manipulation in postprivatization environments have the potential to crowd out more risky investments in long-term enterprise restructuring and innovation.

The possibility for the manipulation of imperfect markets can be developed through an analogy with the difficulty of using market prices to resolve bankruptcy issues. U.S. bankruptcy law under Chapter XI is designed to allow those firms with the potential to restructure to attempt to do so. The question open for judgment is whether the firm's failure is based on short-term fluctuations in markets and credits and, therefore, could be restructured to repay current obligations, or whether the bankrupt firm should be liquidated immediately and its assets distributed under Chapter VII of the bankruptcy law. Bankruptcy procedures are negotiated in court, not placed in the open market, because the very uncertainty of the firm's future income stream makes it difficult for market prices alone to determine the manner in which the firm will be restructured.

Yet, mass privatization deals with a similar question of restructuring by privatizing companies. A profit-maximizing investor or investment fund manager might decide to bypass restructuring a firm, which remains a long-term and highly uncertain endeavor, for the more immediate gains realized through liquidating the most profitable assets of a firm to friendly partners. The lack of regulation and transparent market prices makes it difficult to detect or prosecute the stripping of firm assets for personal gain. In this way the institutional environment immediately following rapid mass privatization policy leads to the development of a set of market incentives that may encourage some private actors to pursue "redistributive rather than productive activity" (North, 1990: 9).

We suggest that the introduction of mass privatization into an environment with no historical institutional infrastructure for market exchange leads to a situation in which formal markets do not facilitate the secondary exchange of property rights in the postprivatization period. This argument is expressed in the following proposition.

> *Proposition 2: Given the absence of a pre-existing institutional infrastructure to support market exchange in postcommunist economies, rapid mass privatization in these environments does not lead to the formation of transparent capital markets that facilitate the consolidation of property rights into the hands of strategic owners.*

Advocates of mass privatization argue that the postprivatization exchange of property rights will lead to the consolidation of ownership into the hands of strategic owners who will have the incentive to restructure firms. In contrast, we suggest in this proposition that the process of postprivatization exchange and restructuring will be longer and more difficult than initially imagined. Given the lack of institutional support for exchange through market contracting, the eventual reallocation of property rights from initial to final owners most likely will take place through off-market deals characterized by private negotiation and inside information, rather than through transparent exchange with fair and open competition.

Illustrating Proposition 2: Capital Market Development in the Czech Republic

Mass privatization in the Czech Republic consisted of two waves occurring between 1992 and 1995. Citizens could buy vouchers for prices representing about 25 percent of their monthly income. The bidding for shares was conducted through an electronic trading system—the RM-System—with terminals located throughout the country. Through several iterations, prices were adjusted with ad hoc intervention to clear the market. Overall, 8.5 million citizens, 80 percent of the entire population, became equity shareholders in the over 1,800 medium-to-large companies auctioned through the Czech mass privatization program. Investment privatization funds (IPFs) emerged as large owners in the Czech program, as over 550 funds collected close to 70 percent of all privatization points throughout the two waves of mass privatization (Coffee, 1996).

The capitalization of the listed Czech stock market reached $14 billion in 1995, which far exceeded the market capitalization in any other post-Soviet economy (Pohl, Jedrzejczak & Anderson, 1995). Moreover, hundreds of new investment funds and financial companies had developed to participate in the newly created financial markets. In short, the conditions for postprivatization arbitrage and exchange had been developed exactly according to the theoretical statements in the mass privatization literature about the importance of secondary market development.

Yet, in evaluations of the success of mass privatization policy, researchers have emphasized that this policy has not led to the formation of a dynamic securities market. Reviews of post-privatization outcomes in the Czech Republic indicate that the secondary exchange of property rights into the hands of strategic investors has moved slower than initially expected (Coffee, 1998; World Bank, 1999). A recent OECD economic survey states that the ownership structures developed through the Czech mass privatization program actually "impeded efficient corporate governance and restructuring" (1998a: 49). A number of factors have contributed to the slow development of capital markets in the Czech Republic.

First, the crosscutting mechanisms of ownership developed through mass privatization created a labyrinth of interenterprise ownership, with large shares continuing to be held through the state. IPFs were often owned by other investment funds and banks. In turn, the largest banks in the country were owned mostly by other banks and IPFs. Moreover, the Czech government held shares in the banks, therefore leading to indirect control of the state over IPFs and enterprises. Instead of solving the problems of unclear boundaries of ownership developed during the socialist era, mass privatization in the Czech Republic only created a new series of interenterprise ownership patterns that made corporate governance and secondary trading difficult to implement.

A second factor in the lack of secondary trading of shares is growing evidence that the managers of investment privatization funds have taken advantage of the lack of market regulation to extract personal gains at the expense of shareholders (Coffee, 1998; World Bank, 1999). Many fund managers have found it more profitable to "tunnel" the most valuable assets of firms to friendly parties than to invest in the difficult task of firm restructuring (Ellerman, 1998; Kogut & Spicer, 1998). Between 1994 and 1996 the shares of closed-ended privatization investment funds traded at an average discount over net asset evaluation of 75 to 85 percent, reflecting little or no investor confidence in these new financial entities (Czech Securities Exchange Commission, reported in World Bank, 1999).

The reasons for investors' lack of confidence in investment funds are illustrated through the example of Harvard Consulting Company, which controlled many of the largest funds from the privatization process. In 1996 the Harvard Consulting Company announced that it was merging its multiple funds into a single holding company, therefore adding another layer of nontransparency into the already closely held company. The price of some Harvard funds declined 22 percent in one week, allowing the owners of the Harvard Fund to buy back many of their shares at a greatly reduced price. The new holding company, Daventree Ltd., is based in

Cyprus, effectively outside the control of the Czech authorities (Coffee, 1998). Other investment companies followed Harvard Consulting Company's example, transforming into nontransparent holding companies with little or no shareholder control.

A third difficulty in the consolidation of ownership following mass privatization has been that most trading has taken place outside formal stock markets, making it difficult, therefore, to judge the market value of a firm through its listed prices (Kogut & Spicer, 1998). A new Securities and Exchange Commission (SEC) has been developed to place stricter regulation over the market, but, as yet, the new SEC is not an independent body and has no rule-making authority (OECD, 1998a). Market capitalization has steadily decreased following mass privatization through the delisting of stocks from formal exchanges because of illiquidity and lack of public information (Prague Stock Exchange, 1997). Total market capitalization of the Prague stock exchange by the middle of 1998 was less than the total capitalization of the Budapest stock market, despite the distinct capital market strategy of the Czech's mass privatization program (FAME Information Services, 1998).

Instead of markets arising naturally from the opportunities for arbitrage and exchange developed through mass privatization, markets in the Czech Republic remain closely linked to the development of new institutional rules of the game. Although some entrepreneurs work to build these new institutions, others take advantage of present market imperfections to pursue shorter-term opportunities at the expense of other stakeholders in the system.

Privatization and Networks

North's (1990) theory of the role of institutions in defining the incentives of individual actors to pursue productive activity provides one explanation of the influence of institutions on economic activity. It begs, however, the important questions of how these institutions are created and how these rules are expressed and made to bear on the behavior of individual actors. Research into industrial networks and districts shows that collective rules of collaboration often arise through the informal norms and beliefs developed from repeated interactions among closely connected firms. A growing body of literature demonstrates that the processes of value creation and innovation are closely embedded in economic and social networks (Granovetter, 1985; Locke, 1995; Powell, 1990; Saxenian, 1994; Uzzi, 1996).

The second way, thus, that institutions influence entrepreneurship is through the relationships reflected in economic networks. From this perspective, entrepreneurship requires more than the identification of opportunities for exchange and arbitrage. Instead, entrepreneurial activity involves the risky and uncertain task of recombining existing assets to form new innovations in production and organization (Schumpeter, 1934).

The work on networks and the social embeddedness of firms grows out of a basic observation that firms and individuals operating in turbulent environments often do not resort to bureaucratic or contractual methods to promote cooperation (Granovetter, 1985; Uzzi, 1996, 1997). For instance, research on Silicon Valley, the German *Mittelstand* in machine tools, and Japanese subcontracting networks has shown that deep social relationships and norms of reciprocity help obviate problems of opportunism while promoting flexibility and information sharing between firms (Aoki, 1988; Friedman, 1988; Herrigel, 1996; Saxenian, 1994). As much as this research has helped focus analysis away from the firm and more toward the network and region of particular sets of interconnected firms, it also has shown how regions develop institutions to make these norms more durable and dynamic over time.

In turn, the work on industrial districts in advanced industrialized economies has shown how public-private institutions arise to help actors manage collective resources, such as vocational training, R&D in local universities, rules of competition based on quality improvements, and cooperative banks and venture capital funds (Locke, 1995; Nelson, 1993; Piore & Sabel, 1984; Sabel, 1994). The sharing of resources and information has become vital to promote innovation and new experiments in products and processes.

Yet, the spreading of risk and resources across firms clearly violates the notion of mutually exclusive property rights and opens the possibility of opportunism. In developing governance structures to overcome these problems, local economic actors attempt to build mechanisms to obtain information on one another's use of common resources and knowledge, to monitor one another's behavior, and to continue learning from one another's mistakes and advances (Hayri & McDermott, 1998; Sabel, 1994). From this perspective, entrepreneurial activity not only emerges from the ability of actors to share risk and information but also grows up alongside of institutions that help to perform these functions.

This view resonates with recent research on communist economies that highlights the prevalence of informal networks of local firm and political actors. Because of the chaotic environment of failed planning and shortage, de facto if not de jure, decision-making rights over assets often devolved from the state center to stakeholders in industrial concerns under communism. At the same time, dense horizontal socioeconomic ties emerged to help managers and work teams, suppliers and customers, firms, and local party members coordinate continual adaptations to the shortage environment. Informal bargaining rules were grafted onto the formal structures, often allowing concerns to act as umbrellas for networks (Kornai, 1980; McDermott, 1998; Stark, 1989).

Because of differing national histories, the patterns of network organization and identification of network members varied. In Hungary relatively more liberal policies, particularly the legalization in 1982 of various forms of enterprises, allowed dense networks of small and medium enterprises (SMEs) to develop, as well as semiformal subcontractors of large state firms to become a burgeoning second economy (Gabor, 1990; Stark, 1989; Szelenyi, 1989). In Poland the liberalization of the Crafts Code in the early 1980s fostered a private sector of SMEs, although mainly in agriculture. In Czechoslovakia, where movement toward market socialism was quashed after 1968, planning experiments allowed firms of certain industrial branches and regional/district party councils to become directly involved in production and financial management. The result was that networks that emerged within industrial associations (VHJs) varied in their authority structures and density of internal subcontracting links (McDermott, 1997, 1998).

From a network perspective, the fall of communism left agents and firms embedded in distinct sociopolitical networks: clusters of firms/agents with strong technical and financial ties linked to particular public institutions that provided both resources and authority to these members. In the previous system, network members often held common or overlapping assets, such as common testing labs, production facilities, and subcontracting relations. In the transformation to a new economic system, network actors must contend with overlapping claims to joint assets, dispute internally competing strategies, and develop new principles of production. New methods of conflict resolution, financing, and risk sharing need to be grafted onto a previous history of contracting developed during the communist system.

Advocates of rapid privatization argue that the informal property relations that have defined the post-Soviet economic landscape should be rapidly reconfigured into formal claims to ownership based on Western conceptions of property rights. The approach creates property rights that are vested in the ownership of individual firms, leading to a classic collective action problem once a collective good common to all network members is transformed into a private good owned by a single member. If a single owner is assigned to a collective asset, this individual owner has the incentive to exclude other firms that had been benefiting from the joint asset at little cost. If no specific owner is given the asset, then no single network member has the incentive to invest in and maintain the value of the resource. Moreover, the high uncertainty of returns to joint restructuring efforts makes it difficult for independent actors to write new forms of market contracts to ensure cooperation in maintaining joint assets and resources.

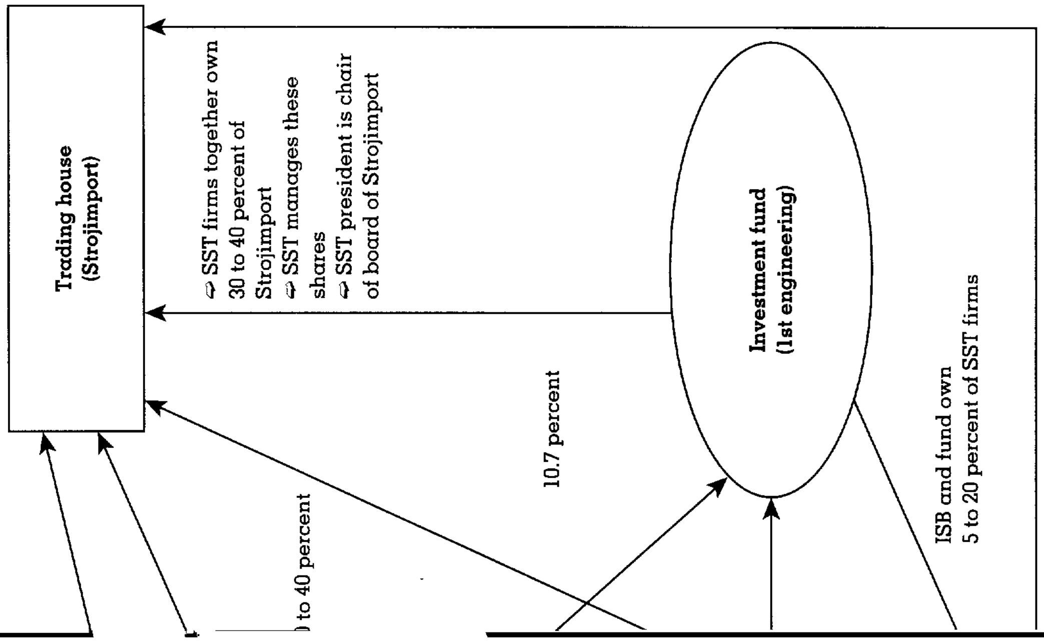
The institutional conditions in postcommunist economies only confound the inherent collective action problems created through rapid privatization. The absence of a legal infrastructure to enforce contracts and property rights makes market solutions to joint asset and coordination problems particularly costly. The lack of formal institutional mechanisms to support impersonal market exchange in postsocialist economies makes the role of informal agreements and relations even more important, leading many firms to pursue network strategies of growth in these environments (Peng & Heath, 1996).

Given the fundamental problems of restructuring networks through market mechanisms in postcommunist economies, the process of privatizing collective assets to individual owners may lead to the erosion of the potential value of the joint assets inherited from the communist system. We express this argument in the following proposition.

> *Proposition 3: Mass privatization erodes potentially productive network*

association system, TST members (including many plants) chose to become legally independent state firms.

With the advent of mass privatization in 1990 and 1991, TST members took two major steps to utilize the new ownership regime to balance individual and common interests. First, the firms chose to enter privatization individually


Trading house
(Strojimport)
SST firms together own 30 to 40 percent of Strojimport
SST manages these shares
SST president is chair of board of Strojimport
Investment fund
(1st engineering)
10.7 percent
ISB and fund own
5 to 20 percent of SST firms
to 40 percent

l Industry

the industry fragmented into insolvency for two main reasons.

First, the uncertainties of new production experiments undermined the cooperation among member firms. As each firm began to experiment with new products or alterations of existing ones, it turned to another for the development or subcontracting of certain components and the cost sharing of exporting and importing. Since these experiments were highly uncertain and often conflicted with one another, no firm could give the guarantees to the others to forego their own plans and invest in those of the solicitor. For instance, with the collapse of trade in the CMEA and the domestic recession, SST firms sought new market niches based on short production runs. These runs were often too short and uncertain to convince other members to drop their own plans and become subcontractors for a given project.

Moreover, the short runs forced members to solicit the joint import of minimum volumes of certain CNC electronics. Yet, the specifications often meant that solicited members were to alter their own designs, which they refused to do. The vocational training system met a similar fate, which severely hurt the ability of member firms to retain existing craftsmen and train new ones.[4] At the same time, distrust and isolation grew among members as they began to encroach upon one another's product niches in a desperate attempt to seek export earnings.

Second, the supporting equity alliances failed to provide needed financing to overcome the hold-up problems among members. As one of the "big five" Czech banks, CSOB was the critical financial link in the alliance. Yet, the combination of the collapse of CMEA trade, new creditor rules, and government enforcement of hard budget constraints left CSOB and Stroiim-1994 four of the five largest de novo banks, including Banka Bohemia, were seized by regulators and closed.

The fragmentation of socioeconomic relationships among SST members and the lack of public institutions to support various aspects of SMEs became fertile grounds for certain members to take highly risky, semilegal steps to acquire needed financial resources and survive. Unable to acquire needed financing from the big five Czech banks or the dominant investment funds, one SST member, ZPS, allied itself with a group of local entrepreneurs, most of whom were former ZPS and big bank employees. Together, they constructed an elaborate network of new small banks and investment funds to channel financing from a poorly monitored state insurance company to ZPS. They used the funds to manipulate share prices and take over several of the fledgling SST member firms. This scheme came crashing down in 1996, when two of their small banks went insolvent and regulators seized the insurance company.

The history of this network points to the problem of seeking to view property rights as vested in the ownership of individual firms. Instead of leading to the eventual restructuring of the interdependent firms in the machine tool industry, the eventual outcome of mass privatization resulted in the collapse of the broader social network that had supported the Czech machine tool industry in the past. In turn, individual firms were unable to restructure in order to compete in the new market environment. The irony of reforms is that adoption of mass privatization reforms did not obviate the importance of negotiated property rights. These negotiations are sometimes "private ordered" insofar as only private parties claim the assets. But these claims are adjudicated in the context of legal statutes ences have powerful effects on the subsequent evolution. In short, this claim is a recognition that there are powerful country effects in determining the precise selection of policies to influence transformation.

Mass privatization theory implies a policy in which the determining role of initial conditions in restructuring is not recognized explicitly. The policy is proposed to solve the problem of property reform via a rapid redefinition of ownership rights through voucher auctions, independent of variation in economic and social conditions at the firm, network, regional, or national level of analysis. In contrast, negotiated property rights reform begins with the recognition that existing social and economic networks are the starting points for new entrepreneurial activities to emerge from the dismantling of the Soviet system. Instead of trying to model the direction of reform on the experience of other countries, proponents of negotiated reform suggest that policies of reform must be built within the ruins of socialism (Stark, 1996).

The danger of gradual reform is that the inclusion of multiple interests into a negotiated process of reform simply might lead to deadlock, with no action at all, or that political considerations will outweigh economic ones. Moreover, in the absence of an explicit program of privatization, managers or state officials separately or acting together might appropriate an enterprise's valued assets for their own personal gain, in what is identified as "spontaneous privatization" (see Boycko et al., 1995, and Kaufman & Siegelbaum, 1997). The challenge for the state in the implementation of negotiated property reform is to develop an institutional mechanism that limits the ability of any single stakeholder, including its own bureaucrats, to sidetrack broad experimentation by appropriating assets for personal profit.

It is critical, however, to pose the question of whether policies of mass privatization are less susceptible to the erosion of institutional mechanisms of control than are efforts at negotiated property reform. As previously discussed, mass privatization does not lead to the formation of a new system of entrepreneurship based on market arbitrage and exchange, nor does it forestall the inherent political problems in renegotiating property rights among multiple claimants to an enterprise or network. In short, mass privatization does not avoid the restructuring of social and political institutions; it simply postpones the challenges of implementing these types of institutional projects. The impact of privatization policies on entrepreneurial outcomes, therefore, does not rest on the choice between state or market in reform efforts or on the speed with which old institutions can be destroyed. A more fundamental question for privatization policies is the manner in which reform efforts interact with existing conditions to advance or hinder the long-term formation of new market institutions that support and structure entrepreneurial activity.

The theoretical underpinning of a negotiated reform process rests on a gradualist perspective on institutional change that suggests paths of economic development are highly dependent on initial conditions and, therefore, difficult to reshape according to predetermined plans. At the level of the firm, this viewpoint is predicated upon notions of relatively inert resources that explain why firms are slow to change (Nelson & Winter, 1982). Since firms develop through a recombination of their existing capabilities (Kogut & Zander, 1992), change is an incremental process involving negotiation and deliberation. At the level of the institutional environment, gradual change is predicated on the embeddedness of organizational action in a broader system of regulatory laws, normative beliefs, and cognitive understandings (Scott, 1995). Processes of institutional change involve not only rapid transformation in the formal laws that prescribe behavior but also in the informal beliefs and understandings that lead to the realization of these rules in everyday behavior (Powell & DiMaggio, 1991). The learning of new routines and practices, therefore, requires time and experimentation as interdependent actors learn to coordinate their activities in new ways (Tolbert & Zucker, 1996).

A number of theorists have stressed the importance of evolutionary processes of change to argue that policy makers in postcommunist economies should not follow Western blueprints of reform but should, instead, incorporate processes of experimentation and local learning into policy design (Kogut, 1996; Murrell, 1992). These authors suggest that the goal of economic transformation is not to obtain the clear set of property rights inherent in Western capitalistic systems but, instead, to encourage the recombination of the existing assets and liabilities of the socialist system to form new endeavors and entities.

From this gradualist perspective, entrepreneurial innovation is best achieved not through the rapid destruction of past organizational forms but, rather, through experiments with forms of common property management via public-private institutions of risk sharing and frequent negotiations. Based on a logic similar to that found in the theoretical literature on industrial networks and districts, this viewpoint emphasizes the importance of aiding private actors to develop new norms of reciprocity that limit problems of opportunism while promoting flexibility and information sharing between firms. Negotiated property reform permits entrepreneurs to experiment with the construction of these new organizational forms and production methods. This experimentation process often prohibits a priori clarification of control and cash flow rights because of the high uncertainties of return and the necessity of economic actors to cooperate in restructuring activities.

Negotiated reform allows processes of creative destruction to reside not only over individual firms but also over the eventual successes, or failures, of different types of reform efforts. Public agencies themselves experiment with institutional forms that directly and indirectly provide financial cushions and mechanisms of collective negotiation for private actors. Public agencies learn not only how to be credible mediators of conflict among multiple parties during the privatization process but also how to define their future role once these property rights are transferred to private parties.

Unlike the uniform and rapid process of institutional change dictated through mass privatization policy, we suggest that negotiated property reform better incorporates processes of experimentation and learning into the evolutionary design of new institutions. This argument is expressed in the following proposition.

> *Proposition 4: Negotiated property rights reform better incorporates institutional experimentation and learning into the process of property transformation in postcommunist economies than does rapid mass privatization policy.*

Illustrating Proposition 4: Institutional Experimentation in Poland and Hungary

The process of institutional experimentation in property reform measures is apparent in both the Polish and Hungarian approaches to property rights reform. Both countries have undertaken reform measures that differ from traditional market auctions for ownership rights through a formal privatization program. Moreover, they have given a distinct role to public institutions in developing new mechanisms of risk sharing and conflict mediation among the parties to the assets. Entrepreneurship is not based on market arbitrage and exchange but, instead, involves a collective project in recombining assets through production and organizational experiments.

Poland. Although many observers of Poland have noted how worker council veto powers effectively blocked mass privatization, few have noted how the very 1990 law legalizing those veto powers enabled employee councils to legally dissolve their firms and rent, lease, or sell the assets to a new corporation (Levitas, 1994). The evolution of this law has arguably produced the most important channels (termed *direct privatization* and *liquidation*) of property reform in Poland. As mass privatization languished, by the end of 1995 these two channels had initiated over 2,507 transfers in ownership (of which 1,450 were completed) or over two-thirds of two ownership transfers in Poland (OECD, 1998b).

These two channels were critical for the development of industrial networks in Poland, since they forced network members attached to large state firms to negotiate with other stakeholders (other firm managers and workgroups, banks, and the ministry) over the method of property reform. Indeed, neither channel was very rapid. For instance, liquidation required approval of the employee council, management board, and the ministry. More than two-thirds of direct privatization took place through leases, again requiring approval from the various parties to the assets. The negotiation mechanisms denied a clean break but allowed actors to gain autonomy gradually for certain assets while maintaining consideration of the strategic interests of other network members. Indeed, one could argue that such a process allowed new production strategies to be grafted onto existing firm-specific subcontracting programs, thus facilitating a continued flow of know-how, financing, and access to R&D and training facilities.

formation of new industrial networks in Hungary during the early 1990s. Former socialist the sales of companies to foreign investors involved informal negotiation among multiple stakeholders (Antal-Mokos, 1998).

The lack of mass privatization has not stopped the transformation of public to private property in Hungary. In fact, by 1998 over 80 percent of Hungarian GDP resided in the private sector (European Bank for Reconstruction and Development [EBRD], 1998). Some commentators have remarked that the lack of uniformity of Hungarian privatization makes it difficult to provide general statements about the policies undertaken, but others have suggested that it is precisely the consistent emphasis on bargaining and negotiation that characterizes the Hungarian experiment (Antal-Mokos, 1998; Frydman, Rapaczynski, & Earle, 1993).

CONCLUSION

The initial debate over privatization methods in postsocialist economies emphasized the importance of speed in property reform. The underlying assumption was that the market itself would lead to beneficial postprivatization outcomes. Yet, a comparative examination of privatization outcomes in the Czech Republic, Hungary, and Poland demonstrates that the choice is not plan or market. The absence of rapid mass privatization programs in Hungary and Poland has not led to the continuation of the planning economy. Markets and private ownership have developed, albeit in a slower, more evolutionary manner.

In fact, a comparison of economic outcomes over the initial decade of reform demonstrates a more rapid pace of industrial restructuring in Hungary and Poland than in the Czech Republic. Similarly, China's efforts at gradual property rights reform effort have demonstrated better economic results than Russia's rapid mass privatization program.

The theoretical propositions we have generated here contribute to an understanding of why the promises of rapid market reform have failed to materialize. The argument concerning mass privatization and negotiated reform is, above all, a dispute stemming from different visions of the entrepreneurial act. The belief that entrepreneurship is essentially an act of arbitrage assumes that markets exist outside of local environments and relations. Yet, as the events in the Czech Republic demonstrate, markets remain closely linked to local contexts, even following radical market reform. The rough information embedded in market prices has not proven capable of facilitating the types of proprietary information exchange and joint governance mechanisms necessary for the uncertain and complex challenge of restructuring state-owned enterprises.

The contrary vision to mass privatization is the proposal that economic progress rides upon the negotiated claims to restructure among interested parties, including the state. The entanglement of liabilities and assets leads to a cat-and-mouse game, in which new owners seek assets while laying the liabilities on other parties, be it banks, firms, or the state. Rapid mass privatization postpones this fundamental restructuring while it weakens dramatically the power of new institutions to reach settlement. Gradual, case-by-case reform, although unquestionably vague in the a priori determination of property rights, permits negotiated outcomes in the presence of strong state representation.

The crux of the difference between mass privatization and negotiation, as we argued in our last proposition, is that transition economies require institutional and organizational experimentation. Auctioning off ownership assigns a uniformity of corporate governance over assets that, in fact, cannot be supported by incipient and weak markets. In its micro operations, gradualism is a process of experimentation in which not only ownership is adjudicated but institutional solutions fail or succeed by trial and observation. Whereas rapid mass privatization policy is strong in the destruction of the prior regime, it is weak in its support for the creation of a new institutional order. It is this balance between creation and destruction that is maintained through a process of gradual property reform that shows recognition of the importance of existing economic and social relations while still allowing for the emergence of new forms of market entrepreneurship and organization.

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Andrew Spicer is an assistant professor at the A. Gary Anderson Graduate School of Management, University of California at Riverside. He received his Ph.D. in management from the Wharton School at the University of Pennsylvania. He is currently studying the role of institutions in the formation of new economic systems in post-communist countries.

Gerald A. McDermott is currently a visiting assistant professor in the Management Department at the Wharton School, University of Pennsylvania. He received his Ph.D. in political science at MIT. His work focuses on the creation of economic governance institutions in emerging market societies, particularly in East Central Europe and Latin America.

Bruce Kogut is the Felix Zandman Professor at the Wharton School, University of Pennsylvania. He received his Ph.D. from the Sloan School, MIT, and was an exchange scholar at the Humboldt Universitaet in the GDR. He is currently visiting at the Centre de Recherche en Gestion, Ecole Polytechnique, and is working on institutions.