INSTITUTIONAL CHANGE AND FIRM CREATION IN EAST-CENTRAL EUROPE
An Embedded Politics Approach

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A central debate about the transformation of postcommunist countries is how political approaches to institution building affect firm restructuring and creation. This debate has largely been dominated by theories that emphasize either the depoliticization of institutional designs or the determining impact of preexisting social structures. By examining the relative economic performance of Poland and the Czech Republic in the 1990s, this article offers an alternative, *embedded politics* analysis that views firm and institutional creation as intertwined experiments. Czech attempts to implant a depoliticized model of reform impeded institutional development and the reorganization of sociopolitical networks, in which firms are embedded. Poland facilitated institutional experiments not only in the ways it promoted negotiated solutions to restructuring but also in the ways it empowered subnational governments. The study utilizes data on manufacturing networks, privatization, bankruptcy, and regional government reforms collected between 1993 and 2000.

Keywords: *institutions; governance; restructuring; postcommunism; transitions*

A **central debate** about the transformation of postcommunist countries is how the process of institutional change affects firm restructuring and creation. Two literatures on economic development have largely dominated this debate. The depoliticization approach, often found in economistic and developmental statist views, understands transformation as discontinuous change. A coherent, autonomous state imposes a new, "right"

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set of rules and incentives on a tabula rasa of atomized firms and banks. Sociological approaches tend to emphasize the continuity of past social structures determining firm strategy and policy choices (Spicer, McDermott, & Kogut, 2000).

The problem is that neither of these approaches offers a convincing explanation for a key development during the 1990s in East-Central Europe: Poland's strong economic growth and the Czech Republic's stagnation. Indeed, advocates of both approaches viewed the Czech case as a relative success and as a major source of supporting evidence.

This article explains the relative Czech failures and Polish successes in the restructuring and creation of manufacturing firms by offering an alternative *embedded politics* approach that attempts to connect productive outcomes to the organization of policy-making power. Industrial adaptation is a product of institutional experiments, which in turn depend on multiple governmental actors having the power to initiate policies and monitor one another.

In this view, firm and public actors under communism created distinct socio*political* networks to obtain resources and to protect themselves from the uncertainties of shortage economies. During the transformation period, firms remain embedded in manufacturing networks but, in contrast to the dominant approaches, are unable to reorganize assets on their own. Although economic interdependencies constrain individual discretion and property rights, neither contractual solutions nor past social ties can mediate conflicts between firms and banks over restructuring. Firm restructuring and creation depend rather on how government policies enable interconnected firm-level actors to negotiate over time their overlapping property rights and the reorganization of assets. As with asset workout and risk-sharing regimes typical of advanced democracies, these processes demand that public actors mediate conflicts, provide partial financial relief, and monitor the new use of assets by private parties. In short, once one accepts that the government must interact with private actors to facilitate investment and regulate markets, the challenge is to define the political conditions that are more likely to lead to the fruitful development of institutions rather than to self-dealing.

This article argues that the Czech government impeded institutional development to aid firm restructuring and creation because of its attempts to maintain a powerful, insulated state and draw a sharp boundary between state and society. In contrast, Polish approaches to privatization, bank restructuring, and even support for new firms facilitated negotiated restructuring and risk sharing because of the way public power was unpacked. A variety of national and subnational government actors were empowered both to explore new institutional roles in the economy and to monitor one another.

Section I critiques the two dominant approaches and reviews the main arguments of an embedded politics approach in light of the stark differences between Polish and Czech policies and their manufacturing outcomes. Sections II and III then explore these arguments empirically. Using primary network data from the Czech Republic, I am able to define the political conditions and policy choices that would impede or aid the reorganization manufacturing networks.[1] I then compare these conditions and choices between Poland and the Czech Republic (Ragin, 1987).

I. EXPLAINING THE DIVERGENCE IN GROWTH AND FIRM CREATION

By the end of the 1990s, Poland was the economic leader in the region, especially over the Czech Republic. Between 1989 and 1998, real GDP grew by 17% in Poland but declined by 4% in the Czech Republic, and Polish industrial output grew at a much stronger and consistent rate than Czech output (see Figure 1). Most of this growth difference was largely due to relative performance in the restructuring and creation of manufacturing firms (Blaszczyk & Woodward, 1999; Klich & Lipiec, 2000). Industrial labor productivity increased by 3 times more in Poland than in the Czech Republic (Kawalec, 1999). Moreover, Poland created many more manufacturing firms—between 1989 and 1997 the share of manufacturing employment by small- and medium-sized firms (SMEs) rose in Poland by 54.2 points and in the Czech Republic by 46.3 points.[2] How can one explain the stark contrast in the industrial restructuring and firm creation?

One explanation comes from depoliticization advocates, who view transformation as a moment of epochal change from communism to capitalism. Depoliticization is the ability of the state to eschew negotiations with economic and social actors about the initial institutional designs and their subse-

1. Although Czechoslovakia (CSFR) split in January 1993, I focus on the Czech Republic. There was strong continuity in policy for the Czech lands before and after the split, as the main economic policy makers for the CSFR and the Czech Republic remained largely the same. All firms analyzed below were always part of the Czech lands as well. The network, firm, and institutional data for the Czech Republic come mainly from my fieldwork between 1993 and 1996, during which time I conducted over 130 interviews with relevant ministerial, bank, and firm actors and collected primary and secondary firm, bank, and sectoral-level data (see McDermott, 2002). The Polish data come mainly from secondary sources cited below as well as interviews with relevant firm, bank, and government officials in February 2002.

2. The Czech data is from the Czech Statistical Office (author's calculations). The Polish data is from the Polish Foundation for SME Promotion and Development (1999).

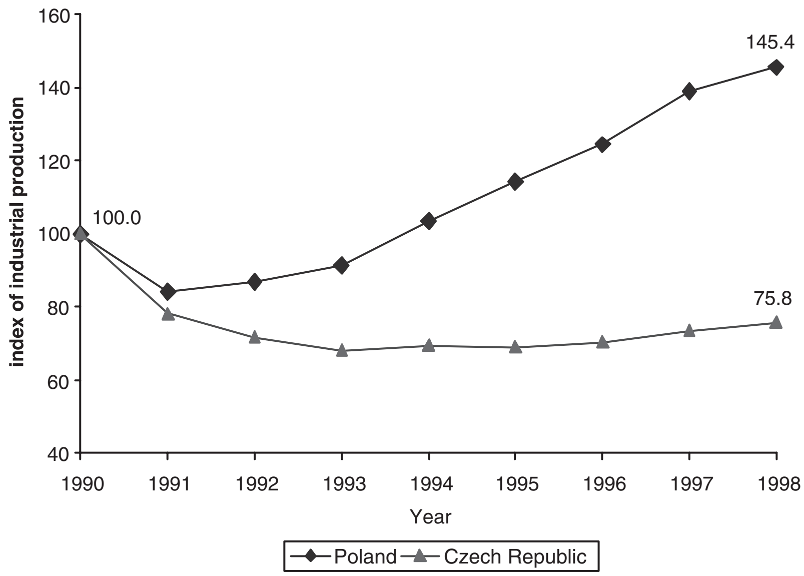

Figure 1. **Industrial production in the Czech Republic and Poland.**
Source: Organization for Economic Cooperation and Development (1999).

quent revisions.[3] It is achieved when the central state constructs a powerful, insulated "change team" to impose rapidly a new set of economic rules (ideally, those of free trade and private property rights) that directly guide atomized firms and individuals toward efficient resolution of restructuring conflicts. Rapid, mass privatization and market liberalization allow various claimants to assets to strike "efficient bargains"—that is, through enforceable contracts, liquidations, and buyouts—so that resources can be quickly directed to fruitful investments and new firms (Boycko, Shleifer, & Vishny, 1995, World Bank Development Report, 1996).

Although one cannot deny the importance of private property rights and market forces, this approach suffers from explanatory problems. First and foremost, by the mid-1990s both independent scholars and the multilaterals viewed the Czech Republic as the crowning success of the depoliticization

3. See McDermott (2002) for a discussion of depoliticization views as they appear in economics, rational choice, and developmental statism. My critique draws on observations by Mood and Prasad (1994), Grindle (1991), and Murrell (1993). For examples see Shleifer and Vishny (1994), Sachs (1990), and Haggard and Kaufman (1992, 1995).

approach, with Poland as the laggard (Boycko et al., 1995; Camdessus, 1994; European Bank for Reconstruction and Development, 1995; Frydman & Rapaczinski, 1994; World Bank Development Report, 1996). Orthodox communist policies had left the Czech Republic with a stable macroeconomy, low foreign debt, poorly organized social and political groups, and a central government with virtually complete legal control of assets. A coalition led by Vaclav Klaus used these conditions to construct a strong policy apparatus that cut itself off from potential "rent-seekers," such as parliament and special interest groups. It weakened workers' councils, dissolved regional councils (blocking their reestablishment until 2000), and reduced the powers and resources of fragmented local governments. The government liberalized trade and most prices and enacted conservative monetary and fiscal policies. It quickly implemented strict banking regulations, a rule-based recapitalization of banks, a bankruptcy law based on liquidation of defaulting debtors, and the privatization of over 1,800 firms and four of the five main banks in less than 4 years through its now famous voucher method.

In contrast, although Poland implemented disciplined fiscal and monetary policies, it delayed firm and bank privatization (European Bank for Reconstruction and Development, 1995; World Bank Development Report, 1996). Policies of partial economic and political liberalization, particularly in the 1980s, left the country with large fiscal deficits and foreign debts and relatively well-organized social groups and competing political factions, notably in Solidarity and the farmer associations. While different political groups competed for policy control, such stakeholders as workers' councils, managers, and local governments intervened in and often exercised veto rights over the privatization of assets. Privatization, in turn, slowed and pursued multiple goals, such as maximizing sales revenues and maintaining employment, rather than simply focusing on the rapid delineation of private ownership rights (Przeworski, 1991). For instance, the Polish version of voucher privatization was not implemented until 1995-1996, concerned only 512 firms (10% of industry and construction sales), and allowed for the state to maintain 25% ownership. Privatization of the major Polish banks did not begin in earnest until the late 1990s (Blaszczyk & Woodward, 1999; Jarosz, 1999; Tang, Zoli, & Klytchnikova, 2000).

As shown in Table 1, the immediate results of these contrasting approaches fortified the view that the Czechs were the leaders of depoliticization. By 1995 the Czechs raced ahead of Poland in private sector control of industry and banking and in the provision of bank credit to private firms. Moreover, while the Czech Republic achieved investment-grade status and its banks exceeded the Basle banking capital adequacy ratios by 1994, studies showed that Czech start-ups and SMEs had relatively greater access to

Table 1
Divergence in Privatization (1995)

	% of GDP in Private Hands	% of Firms in Private Hands	% of Industrial Output in Private Hands	% of Bank Assets Within State Banks
Czech Republic	70	90	93	19.5
Poland	60	46	60	71.1

Source: European Bank for Reconstruction and Development (1996); Pohl, Anderson, Claessens, and Djankov, (1997); World Bank (1996); Tang, Zoli, and Klytchnikova (2000).

bank credit than their Polish counterparts (Bratkowski, Grosfeld, & Rostowski, 1999; European Bank for Reconstruction and Development, 1995).

Second, as both independent scholars and the World Bank have shown, the two proposed motors for firm restructuring and firm creation—the capital market and bank finance—collapsed in the Czech Republic by 1998 (Coffee, 1999; Nellis, 1999; World Bank, 1999). Mass privatization bred a combination of mismanagement by the large investment funds with cross-holdings in the main Czech banks and speculative, insider trader schemes by new Czech entrepreneurs. In the meantime, the Czech use of bankruptcy mainly as punishment and liquidation of delinquent debtors led the banks to view restructuring as too risky. Although nonperforming loans would grow steadily in the 1990s from 19% to 30% of total loans, they would decline from 30% to 10% in Polish banks (Tang et al., 2000). By 1999, as creditors made little progress in voluntary workouts, the Czech government was forced to restructure and reprivatize the banks and seven of the largest manufacturing firms.

Attempts to save the depoliticization approach try to explain the Czech demise and the rise of Polish SMEs by reference to differences in the security of property rights and soft budget constraints (European Bank for Reconstruction and Development, 1999; S. Johnson & Loveman, 1995; S. Johnson, McMillan, & Woodruff, 2000; S. Johnson & Shleifer, 1999).[4] Yet such arguments not only offer little insight into the creation of financial regulatory institutions but also ignore the fact that into the late 1990s the Polish national and subnational governments owned and restructured most large firms and

4. Actually, S. Johnson and Loveman (1995) build on the seminal argument of Janos Kornai (1990). Kornai argued that growth would come from the liberalized second economy. In the meantime, the state would have to reassert governance control over managers in the state sector. But Kornai appears to also draw a sharp line between the new private sector (or new firms) and the existing state sector (see also McDermott & Mejstrik, 1992).

banks, leased firms to employees, and created regional development agencies. In turn, the difference in productive outcomes may be less about rapid state withdrawal and privatization per se and more about how governments developed effective oversight capabilities as well as institutional mechanisms to facilitate the reorganization of assets and liabilities.

The dominant competing explanation about restructuring and firm creation during transformation comes from economic sociology. This approach emphasizes the continuity of social structures, namely, how the structure, density, and strength of past interfirm and professional networks help gauge the ability of firms to cooperate, access new information and resources, maintain market positions, and innovate.[5]

The work of David Stark (1986, 1996; Stark & Bruszt, 1998) is the most prominent here. Stark argued that even after the fall of the party-state, firms remained embedded in constellations of horizontal and vertical socioeconomic relationships that grew out of improvised responses to the uncertainties of the shortage environment during communism. The reproduction of network ties provided constituent firms with reliable channels of resources and information as well as norms of reciprocity to help "recombine" assets in a variety of ways. Network analysis helped scholars compare distinctive patterns of economic organization across countries as well as over time.

However, Stark overdetermines the ability of economic actors to preserve their network relations, particularly in ways that promote restructuring rather than corruption or poor management. For instance, Stark argues that the Czech case is a prime example in which past informal network relationships were reproduced into sound economic governance structures. His evidence is the emergence of the complex interlocking ownership and financial links among the main Czech banks, their investment funds, and their overlapping portfolios of privatized state firms. The decline of Czech restructuring and capital markets would rather suggest that the productive qualities of inherited networks depend on factors beyond socioeconomic relations and, in turn, can be significantly shaped, positively and negatively, by a country's political approach to institutional change.

My alternative, embedded politics approach attempts to identify factors of both continuity and change in firm behavior by understanding how the political-institutional architecture of a country shapes the evolution in the structure

5. The structural sociological views can be found in Putnam, Leonardi, and Nanetti (1993) and Chavance and Magnin (1997). Leading reviews on networks include Granovetter (1985), Powell (1990), Rowley, Behrens, and Krackhardt (2000), Kogut (2000), and Larson (1992). Applications of this work on East European firm restructuring and creation include Spenner, Olga, Suhomlinova, Thore, and Jones (1998) and Sedatis (1997).

and cohesion of industrial networks. Past economic and social ties can initially shape and constrain firm strategy. But the ability of interdependent firms to reorganize these ties and production depends on how countries change the structure of political power to support policy choices about privatization and restructuring (J. Johnson, 2001).

Building on recent research in a variety of East European countries, I argue that upon entering the transformation period, manufacturing firms were embedded in sociopolitical networks, which included regional bank and party council officials.[6] For instance, my own research of Czechoslovak planning in the 1970-1980s showed that midlevel institutions, such as industrial associations (VHJs) and regional councils, took on greater decision-making rights over, respectively, production and social-welfare services (Hayri & McDermott, 1998; McDermott, 2002). Within VHJs, firms and plants developed broad production scopes and tight production and financial interdependencies to limit the uncertainties of shortage. At the same time, managers formed alliances with local state bank branches and party councils to gain privileges from the state center and create informal channels of coordination. These alliances provided certain member firms with political and material resources and thus intranetwork bargaining power that solidified the governance of the network.

This view ties restructuring and the redefinition of property rights into a collective action problem. Because of mutual subcontracting linkages or joint use of R&D plants, part of the value of a firm accrues from other firms in a network, and thus firms have limited individual discretion about how to change production. As these firms pursue competing restructuring strategies, conflicts emerge over production priorities, the use and control of assets, and the division of risk. But resolution is not immediately forthcoming. The lack of information about the returns of a production strategy can be too great for a firm to give credible contractual guarantees to a subcontractor or to a bank to finance the investment or a buyout. Past informal rules of reciprocity lose value because they were derived in part from previous public actors who may no longer be available. For instance, in the Czech Republic, while critical suppliers refused to change production for key customers, the main banks found it too risky to lead restructuring, despite their strong financial linkages

6. For work on the former USSR, Poland, German Democratic Republic, and Hungary, see, for instance, Prokop (1996), Woodruff (1999), Dornisch (1997, 1999), Jacoby (2000), Seleny (1993), Szelenyi (1988), Dabrowski, Federowicz, and Levitas (1991) and Levitas (1994). Even in Stark and Bruszt (1998), there are strong suggestions of the interconnection between local political actors and managers (see, for instance, chap. 4). This approach draws on work on advanced industrial districts, such as Locke (1995), Piore and Sabel (1984), and Herrigel (1996).

with industrial firms. At the same time, the centralization of policy-making power that virtually eliminated regional and local councils also cut intranetwork bargaining power for certain firms. In turn, the force of past norms was diluted.

Solutions to these collective action problems would appear possible to the extent that the interlinked actors can pursue their different restructuring experiments while gradually redefining property rights and building confidence that each will take into account the interest of the other. Such processes are often found in institutions of advanced industrialized countries that support asset reorganization and risk sharing (Berk, 1994; Cui, 1995; Moss, 1996). The common emphasis is to aid stakeholders to risky ventures—for example, firms, workers, investors, and creditors—in simultaneously impproving mutual monitoring and employing assets for new uses. To do so, these state-backed institutions provide limited financial breathing room, incentives for a continued flow of resources, and rules for frequent, disciplined negotiations among stakeholders to exchange property rights and information.

Two political-institutional conditions, in turn, arise to foster firm restructuring and creation. First, to the extent that transformation policies promote institutional mechanisms that help parties to assets negotiate their overlapping claims while sharing risk and information, then these actors are more likely to extend their time horizons, reorganize network ties, invest, and build new firms. For instance, privatization may be less about immediate delineation of exclusive ownership and more about how stakeholders and even new outside interests to firms are able to implement new production experiments while gradually exchanging control rights to different pieces of the assets. Bank restructuring may be less about rapid privatization, recapitalization, and liquidation of delinquent debtors and more about how banks and their major clients learn to restructure assets and redefine the terms of their relationships. In both cases, certain stakeholders are *delegated* different restructuring responsibilities but with limited control rights. At the same time, they submit to rules of frequent joint *deliberations* that demand continuous information exchange and mutual evaluation of actions taken (Sabel, 1994).

Second, the structure of political power can impede or foster the ability of government to become a needed third party in promoting and supervising such activities. The principles of depoliticization would tend to undermine these processes because the emphasis on the centralization and insulation of political power would stifle the ability of public actors to initiate and monitor solutions to restructuring conflicts. On the other hand, public actors at both the national and subnational level are more likely to experiment with their new institutional roles to the extent that they have the requisite discretion and resources. Recent research on the development of institutions that promote investment and risk sharing, be they for workouts, new firms, or new technologies, shows that the principles of *delegation and deliberation* are also central to institutional experiments (Cohen & Sabel, 1997; Sabel, 1994, 1996a, 1996b). By delegating specific restructuring or privatization responsibilities to relevant public and private actors, the central government obtains agents with superior information to execute policies. Frequent deliberations over the goals and progress of a policy between, say, local government representatives or bank supervisors and the relevant managers forces each to reveal new information, compare results, and improve mutual monitoring over the uses of resources.

The emphasis here is on how the organization of political power helps or hinders banks and firms govern the reorganization of manufacturing networks. As the following section argues, the Czech government's attempt to create and maintain an autonomous, powerful, central policy-making apparatus impeded the ability of interdependent firm and bank actors to generate stable collective solutions for asset reorganization. Section III then argues that Poland promoted economic reform programs of negotiated restructuring that linked the reorganization of assets with gradual ownership change. Its policies of public administration also gave a variety of government actors the resources and discretion to participate in and monitor these programs.

II. BLOCKED RESTRUCTURING IN CZECH MANUFACTURING

The Czech depoliticization agenda focused on quickly establishing new incentives for private owners and banks to restructure and create new firms. Rapid, mass privatization, coupled with strengthening of the executive and weakening of subnational government, would not only limit the blocking power of firm stakeholders but also create new equity owners to discipline management and invest. Once recapitalized in 1991, the main banks could use their new creditor rights and the strict bankruptcy law to cut off problem debtors and lead restructuring. Any conflicts among firms and banks over the reorganization of assets would be resolved through contracts, buyouts, and closures, relieving the government of any active role in the economy.

The case of the Czech machine tool sector is an apt example of why the depoliticization agenda actually undermined the stable reorganization of manufacturing assets. In general, scholars have viewed a country's machine tool sector, and more broadly its machinery and equipment branch, as an important gauge of industrial restructuring and exports because of its position in the manufacturing value chain (Amsden, Kochanowicz, & Taylor, 1994; Cohen & Zysman, 1987; Herrigel, 1996). It also has been viewed as a major source of SME creation and flexible specialization worldwide since the mid-1970s (Acs & Audretsch, 1990; Carlsson, 1989; Piore & Sabel, 1984). The Czech machine tool firms themselves formed the backbone of Czech industry since the early 1900s and were recognized as leading players in the international machine tool market for most of the post World War II period (McDermott, 2002). Moreover, after 1989 the Czech machine tool firms embraced privatization and made conscious attempts to reproduce their old network ties.

By 1991 Czech machine tool firms had already began breaking themselves up into 40 firms, with the six largest organizing plants as semiautonomous profit centers. This process of coordinated decentralization came out of the sector's inherited polycentric network structure. For instance, member firms had retained considerable decision-making powers and independent financial accounts, but none was a dominant customer or supplier to the others. This structure of several horizontally associated firms with deep overlapping professional ties is often viewed as facilitating flexibility, coordination, and sharing new knowledge and resources (Kogut, 2000; Larson, 1992; Rowley, Behrens, & Krackhardt, 2000). The firms built on this network form in two ways.

First, the firms and many plants entered the first wave of privatization mainly via vouchers. Second, they sought to balance individual autonomy with group cohesion by grafting indirect equity and financial alliances onto their past social ties. They converted the directorate of their former VHJ into the headquarters of a new machine tool association, SST, in which each firm was an owner. As can be seen in Figure 2, SST used its historical ties to create overlapping equity holdings with FINOP and CSOB, the Czech leaders of international trade finance, and their new private bank, Banka Bohemia, in key investment funds and foreign trade companies. SST and the new equity links would provide members with strategic sectoral information and a common coordinating structure in areas where individually they were weak, such as in foreign trade, shared trademarks, critical inputs, vocational training, and development loans.

By 1995, however, the machine tool network had fragmented and most firms bordered on insolvency. The attempt by SST members to reinforce their past social relationships with equity ties and contracts and also replace past public external partners with new private financial ones did little to promote cooperation and restructuring.

First, the uncertainties of new production experiments created restructuring conflicts between interdependent firms. Given the lack of knowledgeable

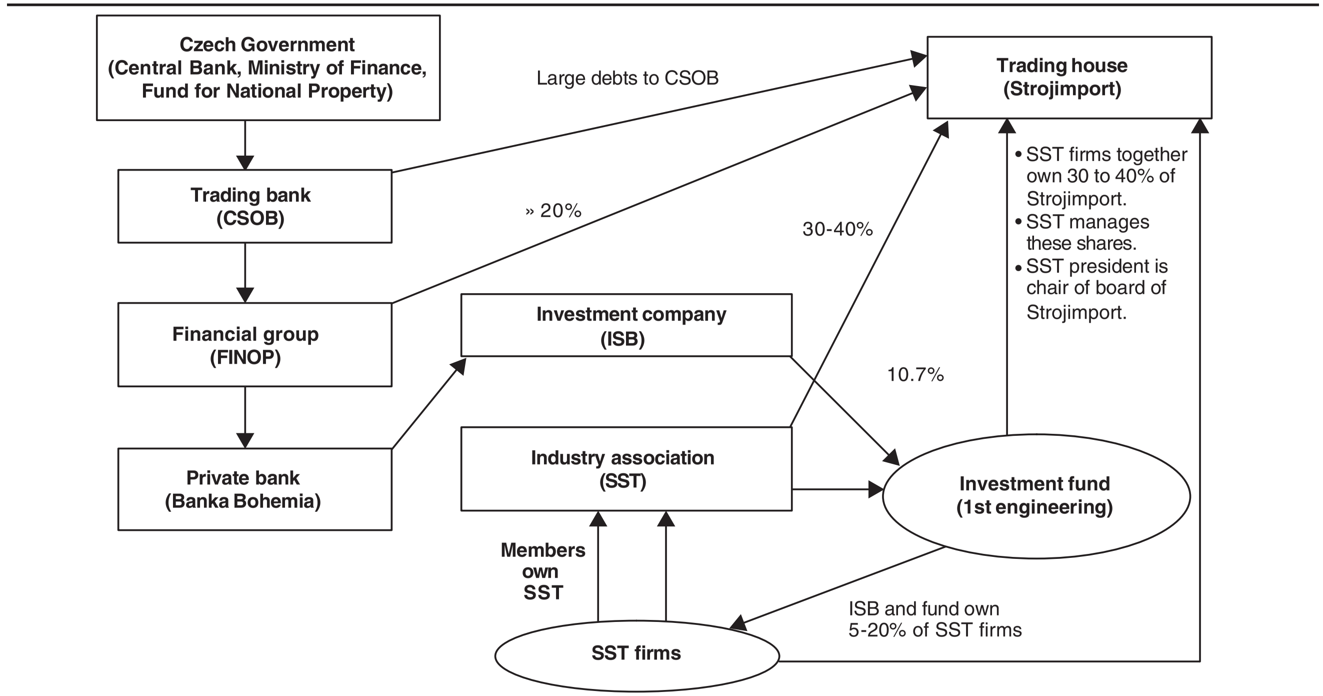

Figure 2. **Network ties in the Czech machine tool industry.**
Source: Adapted from McDermott (2002, chap. 5).
Note: Direction of arrow denotes direction of ownership. Percentages denote ownership share.

suppliers and the high costs of total in-house production, SST firms turned to one another for the development or subcontracting of certain components and the cost sharing of exporting and importing (especially for computer numerical control electronics). Because the strategies of new product development entailed significant risks and often conflicted with one another, no firm could give the contractual guarantees to the others to forego their own plans and invest in those of the solicitor. For instance, even when the solicitor demonstrated that the trial runs were for a credible international client, the small production volumes and poorly defined future revenue streams undermined the credibility of the project. In turn, the potential SST suppliers refused to alter their own component production for the benefit of the solicitor.[7]

Second, the supporting equity alliances failed to provide needed financing to overcome the hold-up problems among members. Even with the government's partial recapitalization and debt relief for the banks, CSOB, like the other "big five" Czech banks, still had weak capital bases and tight financial links with industrial and trade firms. But the big Czech banks found it too risky to lead bankruptcies or finance restructuring via the available governance mechanisms of contracts, liquidations, and ownership (debt-equity swaps; Hoshi, Mladek, & Sinclair, 1998). In turn, the big banks refused to provide credit lines directly to firms or via new banks like Banka Bohemia, and SST firms languished. Indeed, in 1994 regulators closed four of the five largest de novo banks, including Banka Bohemia.

As most collaboration collapsed, ZPS, the largest and most successful SST member, launched a plan in mid-1995 to acquire other SST firms instead of trying to use them as subcontractors. But given ZPS's large debts and the obstinacy of the main Czech banks, ZPS used a group of its own small allied investment funds and new banks to channel financing from their depositors, notably the partially privatized Czech Insurance Company. ZPS and its allies attempted to use these funds to manipulate the share prices of SST firms and gain strategic control of them. This scheme came crashing down in late 1996 when two of ZPS's allied banks went insolvent and regulators seized Czech Insurance.

By tying network reorganization to institution building, an embedded politics approach can make sense of the failure of past social relations and new equity ties to mediate the disputes among SST firms and constrain the domination strategy of ZPS. First, the depoliticization agenda radically altered the network authority structure that underpinned the inherited social capital

7. Similar fates met efforts to clarify firm specializations, collaborate in exports and imports, and use the vocational training system. An added fear was that firms were beginning to encroach on one another's traditional product lines (see McDermott, 2002, chap. 5).

between firms. A key reason for the development of polycentric network during communism was that relevant central bank branches and regional/district administrative party councils had provided many firms of the old VHJ network with political and material resources for bargaining power vis-à-vis other machine tool firms and the central state ministries. Bent on centralizing power during transformation, the Czech government literally and figuratively eliminated the traditional external partners for the firms, removing the power structure that supported the past informal decision-making rules and norms of reciprocity.

Second, to sustain its insularity, the Czech government impeded the development of new institutions for restructuring. Once the government implemented mass privatization and partially recapitalized banks, private contracts and a bankruptcy regime emphasizing liquidation would induce restructuring. Any alternative policies, such as leasing firms, selling assets with typical conditions of restructuring, or promoting workouts as part of bankruptcy, would have linked ownership change and restructuring and required government oversight. Moreover, to do so would have demanded empowering different public actors, be they ministries or subnational governments, with the necessary discretion and resources to share some of the risks and create rules for the relevant parties to negotiate over time the restructuring of both operations and financing. Czech transformation policy, however, strongly curtailed any such delegation of power and public-private deliberations.

As such, Czech firms and their new, private external partners—the main banks and investment funds—were left with no mechanisms to help them extend time horizons, share risk, and monitor one another. Liquidation of industrial firms threatened to destroy the future client base of the Czech banks, and using a contract to forge a mutually binding workout agreement was insufficient to protect their investments and build confidence in one another.

III. ENABLING RESTRUCTURING AND INSTITUTIONAL EXPERIMENTS IN POLAND

As Czech restructuring slumped, Polish industrial output and firm creation accelerated, even in the machinery and equipment branch.[8] Though not

8. According to data from the Polish and Czech National Statistical Offices, for Nace 29, Machinery and Equipment, real production increased from 1995 to 2000 by 5.92% in the Czech Republic and 19.1% in Poland, whereas by 1999, small and medium-sized firms (SMEs) accounted for 35.97% of sectoral employment in the Czech Republic and 41.59% in Poland.

Table 2

Contrasting Approaches to Institution Building

Institutional Issue	Czech Republic	Poland
Ownership change	Rapid, mass privatization via vouchers. Ex-post restructuring by new owners.	Gradual methods linked with restructuring, mostly via liquidation and direct privatization, especially until 1996.
Bank restructuring	One-time partial debt write-off and recapitalization.	Enterprise Bank Restructuring Program (EBRP), 1993-1996, links bank and large firm restructuring.
Firm restructuring	Contracts and strict bankruptcy law focused on liquidation Failed attempt to net-out interfirm debt.	*Large firms*—EBRP *Medium and small firms*—liquidation and direct methods of privatization (e.g., leasing)
Organization of policy making *National level*	Strong, autonomous change team in ministries of finance and privatization focus of rapid implementation of vouchers, bank recapitalization, and new laws.	Ministries of finance and privatization build capabilities to initiate and monitor EBRP and gradualist methods of privatization; build strong regulations for capital market; give roles to subnational governments.
Subnational levels	Regional councils eliminated; districts and municipalities fragmented and weak.	Voivodships (regional governments) empowered to screen and monitor privatizations, assist in EBRP, build regional development authorities (RDAs); *gminas* (municipalities) work with voivodships on restructuring, RDAs, and small and medium-sized firm (SME) support.

always intentionally, the Polish approaches to privatization, bank reform, and policy-making power contrasted sharply with those of the Czechs. Table 2 summarizes these differences in institution building. Firm privatization and bank reform policies largely focused on combining restructuring and ownership change. The government effectively delegated to stakeholders limited property rights that also forced them to negotiate with one another over the reorganization and control of assets. At the same time, different central agencies and subnational governments had the power and incentives to initiate, cofinance, and monitor these activities, often in collaboration with one another. In turn, the Polish transformation approach helped firm and bank actors reorganize their economic linkages while public actors experimented with their new institutional roles.

STAKEHOLDER PRIVATIZATION

The 1990 law on privatization of state enterprises reinforced the veto powers of worker councils and effectively blocked rapid mass privatization. But this law also opened two routes of ownership change that delegated partial use and cash-flow rights to stakeholders of mostly medium-sized firms and plants and gave them incentives to negotiate with one another and restructure assets. By the end of 1996, these routes accounted for more than 68% and 52% of nonagricultural and manufacturing firms, respectively, subject to ownership change. Both routes also accounted for more employment than any other route, except for firms commercialized but still with full state ownership (Blaszczyk & Woodward, 1999; Jarosz, 1999; Nuti, 1999).

The so-called liquidation route, based mainly on Article 19 from 1981, sent firms through a specialized bankruptcy procedure that focused on debt relief and maintaining employment. Over half of assets in completed projects were restructured, kept as going concerns, and sold or leased to a combination of managers, workers, and outsiders. The so-called direct privatization route came through Article 37 of the 1990 law and was the largest and fastest. This law allowed an employee council to legally dissolve its state firm and then have the assets be sold for cash or in-kind contributions or be leased to a new company, usually composed of insiders. By the end of 1996, 98% of projects for the 1,247 firms in direct privatization were completed, far surpassing the completion rates of all other privatization methods. They accounted for almost 30% of all nonbank privatization revenues.[9] Just over half of the employment in these firms was in manufacturing. Over two thirds of direct

9. This figure is generated from total nonbank privatization revenues through the direct and indirect paths of privatization (see Jarosz, 1999, p. 35, Table 4).

privatization projects were from lease options. Lease contracts were 5 to 10 years and aimed specifically to result in gradual management-employee buyouts (MEBOs) through the lease payments. The new company had to have at least 50% of the employees of the original firm and make an initial downpayment of 20% of book value. Research tracking firms in direct privatization has shown that their financial, productivity, and output indicators are better than national and sectoral averages, and by 1998 only 23 MEBO firms had defaulted on their lease payments.[10]

Articles 19 and 37, particularly MEBOs, tied asset restructuring directly to the gradual reordering of property rights. This was possible for three reasons. First, Articles 19 and 37 effectively forced multiparty negotiations, be they for creating a MEBO, keeping a firm as a going concern, or limiting political hold-ups during project selection. Such negotiations between potential owners and stakeholders (e.g., work groups, linked plants, and firms) not only helped limit asset theft by any individual group but also forced the different claimants to begin to take into account one another's interests, vital for the development of product and process improvements that reach across firms. Second, both routes relieved financial pressure on the firms, in turn providing breathing for firms to experiment with different restructuring strategies. For instance, lease contracts for MEBOs used below-market interest rates and offered the option of deferring initial payments for up to 2 years. Although MEBO firms had limited access to new capital investment loans, the financial relief typically allowed them to restructure via incremental organizational, process, and product innovations.

Third, rather than cutting itself off from society and monopolizing power, the central government gained a well-placed agent to mediate between different claimants to assets by delegating project approval and monitoring authority to the 49 *voivod*ships (regional administrations). In becoming the legal founders of most firms, the voivodships could initiate or block a liquidation petition, evaluate direct privatization projects before they were passed to the central ministry of ownership transformation (MOT) for final approval, and negotiate with MEBO candidates about certain terms of repayment. As they had relatively simple criteria and could maintain much of regional employment, the two privatization routes were politically advantageous for the voivodships. But excesses were monitored not only by the MOT and the 17 regional fiscal audit offices of the ministry of interior but also by the relevant

10. In 1990, there were 8,441 state enterprises. By December 1996, 5,592 firms had entered a track of ownership transformation. There were two major systematic studies of 200 of these firms (across industries and regions) in 1995 and 1998 (Jarosz, 1996, 1999; Kozarzewski & Woodward, 2000).

gmina (municipality) officials, which were freely elected, had significant resources, and could monitor regional policies in the voivod council. As we will now see in the next two sections, the political and functional interdependencies increasingly connected the reorganization of economic networks with the creation of regional institutional capabilities.

POLISH WORKOUTS OF BANKS AND LARGE FIRMS

The few studies on Polish manufacturing networks show that renewal of initially acrimonious interfirm relations emerged in part from subnational governments supporting collective problem solving and resource flows from large firms to their SME suppliers (Despiney-Zachowska, 2001; Dornisch, 1997; Yolum, 2001). The latter, however, was hampered by delays in large firm privatization and formal bankruptcy procedures. The Polish government began in 1990-1991 to experiment with different methods of intervention into large firms. The most successful cases were the now well-known turnarounds of the Szczecin and Gdynia shipyards, which had been under severe financial distress (S. Johnson, Kotchen, & Loveman, 1995; Keat, 2002). The government's development bank initiated programs that restructured shipyards' debts to its 1,500 creditors (banks and suppliers) and provided trade insurance to the shipyards' main customers. In return, shipyard management, workers' councils, and key suppliers had to initiate a thorough restructuring of operations and the value chain. Progress was evaluated through regular joint meetings among representatives of government, the main banks, and the groups just mentioned. The eventual privatization of both shipyards resulted in an ownership being divided among management, workers, the central government, relevant local governments, the largest suppliers, and the public.

When the growing stock of bad loans to firms threatened financial stability in 1992, the government viewed case-by-case approaches and court proceedings as too slow. The Czech response was a one-time partial bank recapitalization, after which the incentives from rapid privatization, new creditor rights, and the bankruptcy as liquidation law would propel the main banks to lead firm restructuring. The Polish government rejected this approach, arguing that it would not change bank-firm relations or government oversight capabilities and would destroy value in the meantime (Kawalec, Sikora, & Rymaszewski, 1995). Rather, the shipyard cases became the basis of a broader government-led workout regime that purposefully tied simultaneous bank and firm restructuring to gradual redefinition of property rights. Whereas the Czech approach, which led to failure and another bailout, would cost taxpayers over 25% of GDP by the end of the 1990s, the Polish approach would cost only 7% of GDP (Tang et al., 2000).

In 1993, the finance ministry launched the Enterprise and Bank Restructuring Program (EBRP).[11] The government offered seven of the nine main commercial banks (which held about 60% of outstanding enterprise debt) a one-time recapitalization sufficient to deal with classified debts that originated prior to 1992. In return, the banks had to establish workout departments and had to reach a debt resolution agreement with their main debtors by March 1994, to be fully implemented by March 1996. Such an agreement allowed for five paths, including demonstration of full debt servicing (about 40% of the 787 total firms), bankruptcy, liquidation, debt sale, and a new regime called "bank conciliation." This last route became the most popular method of dealing with problem firms (23% of firms and 50% of debt) and was widely judged by outsiders as a successful, efficient policy that significantly improved the performance and governance of banks and firms (Gray & Holle, 1998; Montes-Negret & Papi, 1996).

Because the EBRP, and conciliation in particular, demanded regular government evaluation of decentralized actions taken by banks and firms, the governance principles again were a delegation of restructuring authority to stakeholders, multiparty risk sharing, and government monitoring via iterative deliberations among the parties to assets. First, the deputy finance minister purposefully used regular deliberations to enhance monitoring and learning. After receiving the restructuring authority and the basic criteria of the EBRP, the lead managers of the workout departments of the seven banks met together every month for over a year with relevant representatives of the finance ministry, the privatization ministry, the central bank's supervisory division, and the state auditor. In these meetings, the banks had to reveal how they were and were not making progress in the restructuring of their own balance sheets and the firms. The collective, iterative evaluation process created a constant flow of information, which government officials and bank managers used to compare and rate one another's actions over time, detect flaws, limit favoritism, and negotiate updated terms of workouts. At the same time, the deliberations allowed the banks to learn from one another the pitfalls and benefits of different restructuring methods and the government actors to learn how to improve their own auditing and monitoring techniques.

11. I draw here mainly on the works of Gray and Holle (1998), Dornisch (1997, 2000), and Montes-Negret and Papi (1996) as well as on interviews in February 2002 with participants in the Enterprise and Bank Restructuring Program (EBRP) from the ministry of finance, National Bank of Poland, and former executives of the bank in Lodz.

Second, a similar negotiation process with creditors, firms, and regional public officials took place at the regional level. For instance, in his detailed analysis of the turnaround in the heavily industrialized region of Lodz, Dornisch (1997, 2000) notes that the negotiations between the regional bank, voivodship (as the founder of the firms), the local tax office, and firm management led to new channels of information sharing. As the voivodship learned to forge compromises between the bank and firms, the three parties extended workout negotiations to include the gradual reorganization of supply networks. As a result, the EBRP framework not only helped large firms and their suppliers redefine the terms of their common production lines but also led the bank to develop new services. The Lodz bank soon developed successful regional equity and venture capital funds out of its workout department. This bank and others also developed special write-off provisions for SME suppliers of the large firms included in the EBRP.

Taken together, direct privatization and the EBRP created concrete frameworks for stakeholders to pursue restructuring experiments while gradually redefining their common claims to assets. To support and effectively monitor such negotiated solutions, the central government could not isolate itself but had to empower public actors at various levels of society. This marks a third fundamental difference between the Polish and Czech approaches to transformation: the distribution of public power. Regional and local governments in Poland were facilitating network reorganization not simply as agents of the central state but also as builders of new institutional capacities in their own right.

INSTITUTION BUILDING AND THE POLITICAL MATRIX OF SUBNATIONAL GOVERNMENTS

Both Polish and Czech reformers were highly concerned about continued control by communist apparatchiks of regional and local councils and maintaining a unitary state. But their methods of dealing with them contrasted sharply.[12] The Czechs eliminated regional councils, allowed municipal and district councils to fragment into numerous small, uncoordinated units, and restricted their participation in economic reforms. In contrast, the Poles maintained 49 voivodships (regions), and gminas (municipalities) were con-

12. For instance, the number of Czech municipalities grew by 50% by 1991 to 6,237, with an average size of 1,700 inhabitants, whereas Polish *gminas* maintained most of their integrity (2,466 gminas with average size of 15,000 inhabitants). For analysis of the political, resource, and financial differences, see Organization for Economic Cooperation and Development (2001), Baldersheim, Illner, Offerdal, Rose, and Swianiewicz (1996), Gorzelak (1998), Levitas (1999), and Innes (2002).

siderably fewer and larger than their Czech counterparts, with greater stocks of resources and autonomy over revenues and expenditures (Organization for Economic Cooperation and Development, 2001). For instance, Gorzelak (1998) estimates that gminas provided about 50% of new public infrastructure in Poland during the 1990s. This resource distribution provided sources of policy initiative as well as the basis for intergovernmental bargaining power and monitoring within the regional political matrix.

On one hand, a voivodship governor was directly responsible to the central government, had specific mandates in privatization and restructuring, and was charged with ensuring the legality of gmina policies (Regulska, 1997). On the other hand, voivodships could not ignore the gminas. The central government usually consulted with gminas over the appointment of a voivod governor. The voivod council, composed of gmina representatives, reviewed all voivodship policies, although the gminas did not have formal veto powers other than withholding resources and lobbying the central government. In turn, the Polish government economic reforms not only employed well-positioned agents to implement policy but also triggered a variety of public actors to monitor and collaborate with one another in supporting firm restructuring and creation within the well-balanced matrix of political autonomy and interdependence.

To become an effective participant in policies such as direct privatization and the EBRP, a voivodship typically combined its relative authority and organizational resources with the social, informational, and human resources of the regional bank, firms, consultants, gminas, and the audit agency. These initial steps became a resource for gminas and economic actors to expand their portfolios of strategies, collaborators, and project-screening capabilities. For instance, when the EBRP was launched, the regional banks lacked effective monitoring capabilities. In turn, they began to supplement their deficiencies by participating in regular voivod council meetings and accessing the voivod database. The pilot experience in restructuring firms in EBRP, and in some case becoming co-owners of them, led the Lodz Bank and voivodship to comanage a closed World Bank investment fund for initially 20 firms (Dornisch, 1999, 2000).

This interaction led to a dramatic rise in local and regional public-private institutions, such as 1,500 business support centers and 23 mutual loan guarantee funds, to support large firm restructuring, SME growth, and manufacturing networks (Gorzelak, 1998; Woodward, 2001; Yolum, 2001). Such institutions grew out of regional development agencies (RDAs). By 1996, Poland had 66 RDAs throughout the country, whereas the Czech Republic had only 2. With initial support of the Polish Agency for Regional Development and the Industrial Development Agency (IDA), gminas, voivodship, and firms created RDAs mainly to provide low-cost services to new and transforming state firms that alone could not access them. As RDAs are typically joint stock companies, the most significant owners are usually voivodships, gminas, and the IDA. Firms saw RDAs as critical sources of consulting, training, investment promotion, business incubators, and loan guarantees (Gorzelak, 1998). Indeed, when comparing regions, researchers have found high and strong positive relationships between the density and diversity of public-private institutions, on one hand, and relatively high rates industrial restructuring, participation in direct privatization (especially via MEBOs), SME creation, and the reception of foreign direct investment on the other (Hausner, Kudlacz, & Szlachta, 1995, 1997, 1998; Jarosz, 1999).

Although initiatives related to RDAs and firm restructuring were often fraught with delays and failures, the political and resource interdependencies demanded that the relevant regional public and private actors continually renew the process of collective problem solving (Dornisch, 1997, 2000). In being forced to jointly administer and evaluate privatization, restructuring, and development projects early on, the relevant firm, bank, and government actors began to learn about how to monitor one another and share authority over common assets. This experience in turn helped them define a reasonable set of new common projects and how to assess one another's actions and contributions. Institutional development was not coming from a grand design from above but from stakeholders finding ways to address one another's interests while experimenting with new institutional roles for the demands of asset reorganization.

IV. CONCLUDING REMARKS

This article has argued that an embedded politics approach may prove more useful than depoliticization and continuity approaches in analyzing restructuring and firm creation, at least in East-Central Europe. Similar to recent work by Centeno (1994), Jacoby (2000), Johnson (2001), and Woodruff (1999), my approach is an attempt to bring issues of political power and democratic governance back into the debates on institutional change and economic reform. The value-added of my approach is that it is more explicit about how the distribution of political power can affect both productive outcomes and the open-ended process of constructing new institutions.

Sociopolitical networks mediate between two simultaneous, interdependent experiments—micro-level experiments by firms and banks to reorganize common assets and macro-level experiments by policy makers to build new institutions. The restructuring of networked assets demands institutional workout mechanisms that help the different claimants negotiate over time the redistribution of risk and property rights. Because public actors are both constituents to networks and often key players in such institutions, restructuring in turn depends on the ways that different national and subnational organs are given the legitimacy and resources to explore their roles as risk sharers, initiators, and monitors of the negotiations.

At one level, interlinked firms and banks are attempting to learn how construct new formal and informal methods of mutual monitoring and project selection. This is where asset restructuring is tied to network reorganization. At another level, public actors, be they the central agencies or regional governments, are learning how to provide financial and organizational support to firms and banks while experimenting with different ways to monitor the latter. In turn, the embedded politics approach argues that public actors are most effective in combining learning and monitoring, for themselves and for economic actors, when transformation policies are based on the principles of delegation and deliberation.

This article has tried to show that Poland created political conditions more conducive for institutional experimentation. Czech impediments to institutional experiments came not only from the government's attempt to privatize firms and banks rapidly but also from its attempt to create and maintain an autonomous, powerful, central policy-making apparatus. In contrast, Poland's relative economic success in the 1990s came from economic policies that linked the reorganization of assets with gradual ownership change as well as policies that gave a variety of government actors the resources and discretion to participate in restructuring and monitor one another's actions.

In trying to connect the politics of institutional change to economic restructuring, my argument invites two areas of additional scrutiny. First, the article suggests that the creation of public-private institutions that induce risk sharing and mutual monitoring are vital to economic development. I have emphasized here the role of workout institutions, but institutions that promote foreign direct investment, mortgage markets, SME lending, lender of last resort, deposit insurance, limited liability, and subsidized working training and R&D are all equally important in both developed and less developed countries. The importance of such institutions is that they help private actors invest in relatively uncertain activities while providing systemic stability. They however open up the risks of moral hazard and adverse selection because of the inherent socialization of risk. But just as the creation of investor protection institutions demands government oversight and enforcement capabilities, so too do these other institutions demand the creation of government capabilities to initiate and monitor risk-sharing programs. The dual challenge for researchers is not only to determine the impacts of such institutions on productive outcomes but also to capture how public actors experiment with these new roles. This experimentation is above all about building up effective monitoring capabilities to learn where government is needed most and how it can ensure efficient use of public funds.

Second, this article also suggests that organization of political power affects the governance of institutional experimentation. My discussion of the importance of subnational administrations was meant simply to illustrate that institutional experimentation requires, at a minimum, the empowerment of a variety of government actors to explore different policy approaches and have the political voice to relay them back to higher level bodies. There is a significant body of research on advanced industrialized countries (Herrigel, 1996; Locke, 1995; Piore & Sabel, 1984; Saxenian, 1994), developing countries such as Brazil and China (Oi, 1999; Tendler, 1997), and even Russia (Petro, 2001) that show that subnational governments play critical roles in facilitating economic development and becoming laboratories for new public policy. At the same time, however, it would be misguided to think that simply decentralizing is the answer to development, as it can equally turn into grounds for local strongmen and corruption. Rather, the evidence presented on Poland suggests that effective institutional development comes not only from empowering local public and private stakeholders but also how policies and political institutions are created to enhance mutual monitoring. Indeed, the research on Russia (Woodruff, 1999), China (Oi, 1999; Oi & Walder, 1999), Brazil (Tendler, 1997), and Argentina (Jones, Saiegh, Spiller, & Tommasi, 2002) has also shown that the differences in the distribution and governance of policy-making power among subnational governments can account for the ability of countries to initiate and sustain institutional reforms.

I have argued that the governance principles of delegation and deliberation may turn the potential for local abuse and self-dealing between public and private actors into benefits for the public welfare. In this view, the ability of the 1999 reforms in Polish subnational governments to sustain the gains made in the 1990s would depend on how the reforms supported or undermined these governance principles. Whether you fully agree with that argument, though, is perhaps less important than moving research on economic development away from the ideal designs at the commanding heights and toward the way polities govern institutional change at multiple levels of society.

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