Fiscal and Regulatory Impediments to the Entry of New Firms in Five Transition Economies

Iraj Hashi
Jan Mladek

ABSTRACT. This article focuses on the impact of fiscal and regulatory measures, at various levels of government, on the establishment of new businesses. We are interested in finding out whether, and to what extent, the existing rules and regulations (in particular the fiscal and regulatory frameworks) have impeded the entry of new firms in the early stages of transition. We are also interested in comparing the impact of such impediments amongst countries in different stages of transition. The paper is based on a survey of nearly 400 newly set up (de novo) firms in the Czech Republic, Hungary, Poland, Albania and Lithuania, all established in the 1992-94 period: We concentrate on four specific areas of regulation: registration and licensing of new businesses, rules governing the purchase or lease of commercial real estate, labour and employment laws, and the fiscal rules (taxes and contributions) to which new enterprises are subjected. (Article copies available for a fee from The Haworth Document Delivery Service: 1-800-342-9678. E-mail address: <getinfo@haworthpressinc.com> Website: <http://www.HaworthPress.com>)}

KEYWORDS. Barriers to entry, fiscal constraints, regulatory constraints, shadow economy, corruption

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INTRODUCTION

The massive deregulation of economic activities was a fundamental feature of transformation in all Central and East European countries. The all-pervasive system of state control established under socialism was inappropriate for these transforming economies and had to be replaced by a completely different set of rules and regulations designed to facilitate the establishment of a market economy. While the vast machinery of the former system was being dismantled, the state had to assume new functions and formulate the "rules of the game" appropriate for the operation of the new system. Given the legacy of the old system and the manner of its disintegration, new rules had to be devised at the same time as the new system was taking shape. It was therefore inevitable that the new regulatory framework would develop unevenly in different countries and that some countries would suffer from a "regulatory vacuum," a near-total-absence of an appropriate regulatory framework for the protection of citizens' economic interests. In other countries, many of the old rules and regulations were retained until new ones could be promulgated—a policy broadly aimed at preventing opportunism.

The newly elected governments had to design new rules and regulations for various aspects of economic activity, including the conditions of entry and operation of new firms. The process was by definition time consuming since changes in regulations also required various legal changes which could not be brought in immediately. New regulations ranged from those dealing with the registration and licensing of new firms, to fiscal regulations governing taxes, social and health insurance and other contributions, accounting and financial rules covering book keeping, expenses, depreciation, and banking, labour code governing conditions of work, minimum wage, dismissals, etc., real estate regulations dealing with conditions of lease or sale of commercial property, and many others.

The aims of government regulations, in market economies or in transition countries, are not always explicit. Sometimes they are expressed in terms of correcting market failures arising from externalities or asymmetric information (establishing minimum standards in the interest of consumers, and licensing of certain activities and professions) at other times in terms of promoting public welfare and protecting citizens against unscrupulous businessmen (employment laws, tenancy laws, etc.). Mostly, however; they are designed to facilitate the identification of economic units for tax purposes (tax base) and to ensure that the state treasury receives its dues.

But these rules and regulations, useful as they may be, play an additional, rather negative, role too. Regulations affecting entry and survival of firms put politicians and bureaucrats at different levels of government in a strong position to exercise influence over new firms. They provide the politicians with legitimate means to pursue their own objectives—which may range from extracting a rent, to using subsidies to create employment in friendly companies and areas, favouring their political allies and penalising their opponents. Taxes, subsidies and various contributions may also be used to achieve the same objectives. The success of transition policies is closely bound with the way governments and politicians use their newly acquired (or retained) powers to control the entry and operation of new private firms (see Frydman and Rapaczynski 1991, Shleifer and Vishny 1993 and 1994, Boycko et al. 1996, Shleifer 1997, and Claessens and Djankov 1998 for a discussion of the role of government and the relevant empirical evidence).

It is well recognised that the newly established private firm sector is the engine of growth in transition economies (Blanchard 1997; Blaszczyk 1997). This sector is free from the problems of enterprise restructuring and new investment financing faced by both privatised
and state-owned companies. However, the establishment of new firms and the growth of this sector are closely influenced by the nature of the existing regulatory framework and the extent of the discretion exercised by politicians. The politicians' attitudes have a crucial impact on the entrepreneurs' decision on whether or not to enter a market. In some transition economies, such as Russia, many old style politicians hostile to the market system have retained their position of power and have engaged in "predatory" actions against new firms. In other countries such as Poland, on the other hand, politicians responsive to the needs of the newly emerging market economy have facilitated the growth of registered new businesses. For example by 1995, the number of new businesses had reached 2 million in Poland and only one million in Russia (with a population four times larger) (see Shleifer 1997; Chmiel 1998). In effect; politicians exercise control rights over firms through a variety of regulations including the registration and licensing requirements, sale or lease of real estate; the level and type of taxes and contributions, and rules governing exports and imports. Furthermore, in addition to central authorities, regional, municipal and local governments to devise their own rules and regulations-to pursue their own objectives-which erect further obstacles for the newly established firms.

There is no hard and fast rule about the optimum level of regulation-a level that has to be worked out for each country or industry separately. On the one hand, of course, the establishment of a market economy requires the abolition of the system of rules and regulations which was in force under socialism. On the other hand, the new system requires its own new "rules of the game" aimed at creating a level playing field for all participants. While governments should provide sufficient "space" for entrepreneurs to engage in rightful economic activities, it should also ensure that no one's rights (including the citizens' and the state's) are violated by the emerging entrepreneurs. In some areas such as environmental protection or the financial system, many countries still do not have sufficient rules to protect their natural environment or their citizens' financial interests against unlawful activities of new firms (often in the informal sector) and their self-seeking managers.

In areas such as taxation, on the other hand, the legacy of the socialist system (with its massive state sector and high levels of expenditure) led to the imposition of very high levels of taxes and contributions and to too many complicated and constantly changing rules. The resources used for the "safety net" (e.g., unemployment and other social benefits) were often misused because of the absence of an appropriate monitoring system and suitable rules. It is clear that if the government does not take a conscious and clear view of the appropriate level of regulation, either it will submit to the demand for "excessive" regulation from different levels of bureaucracy or it will not bring in the basic regulations which are necessary for the development of a market economy.

The impediments to private sector development also play an important role in pushing some entrepreneurial activities into the shadow economy. Naturally, many new businesses wish to evade what they consider "excessive" levels of taxes and "troublesome" rules and regulations if at all possible. To this end they may try to conduct some or all of their business outside the formal sector. This will have a distorting effect on the development of the private sector as well as major implications for government finances. A shortfall in government revenue will reduce its ability to provide the normal services expected of a government in a market economy-including policing of the informal sector. This will create an incentive for more entrepreneurs to try to shift some of their activities into the shadow economy, reducing government's revenues and its normal expenditure programme further. The available evidence from transition economies shows that the size of the shadow economy is related to the level of
"legal protection" and "legal effectiveness" provided by the government. These services, in turn, are dependent on government's revenues and its taxation policies (see Johnson et al. 1997).5

The present paper is concerned with the impact of fiscal and regulatory measures taken at various levels of government (central to municipal) on the establishment of new businesses. We are interested in finding out whether, and to what extent, the existing rules and regulations (in particular the fiscal and regulatory frameworks) have impeded the entry of new firms in the early stages of transition. We are also interested in comparing the impact of such impediments amongst countries in different stages of transition. The paper is based on the experience of nearly four hundred newly set up firms (de novo) in five transition economies: the Czech Republic, Hungary, Poland, Albania and Lithuania.6 These firms, all set up in the early transition period, had faced a number of regulatory and fiscal barriers in the course of their establishment and early growth and had to overcome them. The firms were selected from a wide range of activities; sizes and locations in order to highlight the main barriers faced by new firms in these economies. The countries are divided into two groups at different stages of transition: the Czech Republic, Hungary and Poland who were the first transition economies and Albania and Lithuania who embarked on this road two years later in 1992:

The paper concentrates on four specific areas of regulation: registration and licensing of new businesses, rules governing the purchase or lease of commercial real estate, labour and employment laws, and the fiscal rules (taxes and contributions) to which new enterprises are subjected. The paper is divided into six sections. The first section discusses the characteristic features of the 400-firm sample on which the study is based. The next four sections discuss the responses of our sample firms to each of the four areas of regulation. A number of concluding remarks are presented in the last section.

SAMPLE

The sample consists of 396 newly established enterprises, one hundred each in the Czech Republic and Hungary, ninety-six in Poland, and fifty each in Albania and Lithuania. Sole proprietorships and businesses run by physical persons were excluded. Enterprises were selected from lists obtained from a variety of state institutions depending on the situation in each country. These included Company Registers kept at courts, statistical agencies, associations of entrepreneurs, and employers' organisations. The sample in each country also had to conform to certain rules regarding the firms' activity, size and location in order for it to be as representative as possible.

Activity

Only four branches of economic activity were chosen for this study: manufacturing, construction, trade and services (as specified in NACE industrial classification). The primary criteria for the selection of the sample was that it should reflect the share of these four sectors in the national economy (by employment). Of course other criteria such as size, regional location and the legal form were also applied in sample selection. Therefore, in the end, the sample did not precisely reflect the sectoral composition of national economies. Figure 1 represent the sectoral make up of the sample in five countries. Firms in trade and services constituted nearly half (or more) of the sample in each country, reflecting the fact that the bulk of new firms entered these sectors in all transition economies.
**Date of Establishment**

All enterprises in the sample were new private firms, established in the early transition period, 1990-1994. As such they would have faced, and overcome, a variety of impediments to their establishment and early growth which are of interest to this paper. Figure 2 represents the distribution of the sample according to their year of establishment.

**Size**

Given that newly established firms are invariably of small and medium size, the sample concentrated on firms with a full-time employment of less than 200 in mid-1997, when the interviews were conducted. Figure 3 shows the size distribution of sample firms in each country.

As the table shows, smaller firms; employing 5-50 people (fulltime) constituted between 59% and 82% of the sample: This reflects both the nature of new entries under conditions of transition and the size distribution of private firms in the economy as a whole (where larger firms are less common). Firms in transition economies usually employ many part-time or "free-lance" workers-for the latter group they do not often pay social and health insurance contributions. Figure 4 shows the average number of full-time and part-time employees (in 1995) in the five samples.
Legal Form

In general in transition economies, most new firms (as with sole proprietorships or physical, persons) are small, and the "limited liability" is the dominant legal form. Partnerships and "Joint Stock" companies (and co-operatives) are rather rare.

FIGURE 2. Date of Establishment of Sample Firms

FIGURE 3. Distribution of Sample Firms According to Their Size (Full-Time Employment in 1995)

FIGURE 4. Average Number of Employees in Sample Firms in 1995
The high level of initial capital required to establish a joint stock company (see Table 1) is one of the main reasons for this pattern. Figure 5 shows the legal form of companies in the sample.

In order to widen the geographic base of the sample and to mitigate the bias towards the capital cities (which face very specific conditions in terms of demand, costs; input markets and exposure to information as well as technology), a proportion of the sample (ranging from one quarter to one third) was selected from a less developed region of each country: the districts of Prostejov and Olomouc in Central Moravia in the Czech Republic; the Hajdu-Bihar district in Hungary; the districts of Koszalin and Lomza in Poland; the city of Elbassan in Albania, and the city of Kaunas in Lithuania.

Time and expense constraints meant that it was not possible to have a sample with a wider regional distribution but given that a large proportion of new firms have been set up in or around the capital and large cities, we believe that the sample provides a fairly representative picture of the problems faced by new firms in the early transition.

Finally, it has to be pointed out that, irrespective of its representativeness, the sample consists only of firms that have succeeded in overcoming the entry barriers of the early transition period. Many entrepreneurs have failed to enter the market because of high barriers and we have not been able to include them in our survey because of the absence of information on "failed entry attempts." However; even though our sample is biased towards the successful entrants, we believe that they have experienced the difficulties faced by all new firms in this period and are able to identify the nature of different constraints and their relative importance.

TABLE 1. Initial Capital Requirement for Two Main Legal Forms of Business (in US$)\(^a\)

<table>
<thead>
<tr>
<th></th>
<th>Albania</th>
<th>Czech Rep</th>
<th>Hungary</th>
<th>Lithuania</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited liability company</td>
<td>730</td>
<td>3,000</td>
<td>12,000</td>
<td>2,500</td>
<td>1,025</td>
</tr>
<tr>
<td>Joint stock company</td>
<td>73,000(^b)</td>
<td>30,000</td>
<td>80,000</td>
<td>25,000</td>
<td>25,640</td>
</tr>
<tr>
<td>% to be paid in cash</td>
<td>50(^c)</td>
<td>100</td>
<td>25</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^a\) At August 1999 exchange rates.
\(^b\) For joint stock companies without a public offer, this figure is $14,550.
\(^c\) In cash or kind

**FIGURE 5. The Legal Form of Sample Firms**
REGISTRATION AND LICENSING OF NEW BUSINESSES

Registration and licensing processes are commonly regarded as major barriers to the creation of new firms: To begin with, the initial capital required for the registration of limited liability and joint stock companies is relatively high in all transition economies—particularly for the latter form. Moreover, there is a great deal of variation across countries which is not related to the extent or the degree of the development of the market system. As Table 1 shows, the initial capital needed for a limited liability company varies between US$730 (in Albania) and US$12,000 (in Hungary) and for a joint stock company between US$25,000 (in Lithuania) and US$73,000 (in Albania). These high levels of initial capital requirement are bound to discourage the entry of some new enterprises—or at least their entry into the formal sector of the economy.

In addition to the high initial capital requirement; the registration and licensing processes usually involve visits to a variety of institutions—courts, tax offices, social insurance offices, statistical agencies, banks, the police, and one or more government ministries issuing activity-specific licenses. Managers were asked to evaluate the difficulties or the time consuming nature of various stages of this process on a 1-5 scale (with 1 indicating a very easy stage and 5 indicating a very difficult stage). Their assessment of the difficulties involved in different stages of this process are shown in Figure 6.

Most of these stages are easily dealt with in all countries. Registration with the tax office, social and health insurance organisations and statistical agencies, opening a bank account, and obtaining a clear criminal record are fairly easy in all five countries. The court registration and licensing stages, however, are perceived as more problematic than other stages in all countries. Court registration is compulsory in all countries, except in Lithuania; and is a time consuming affair everywhere. Depending on their particular activity, new firms are also required to obtain a license. Activity-specific licenses are fairly easy in the Czech Republic and Hungary but they are considered a major burden in other countries. The renewal of these licenses are also fairly easy in all countries except in Albania and Lithuania where they become a moderate problem.

FIGURE 6. Difficulties of Different Stages of Registration* and Licensing

*Court registration is not required in Lithuania, nor is registration at the statistical office required in Albania.

**Difficulties are ranked on a 1-5 scale with 1 indicating an easy stage and 5 a very difficult stage.
The licensing difficulties may be partly explained by the fact that in the Czech Republic, a central office in each district deals with the licensing needs of new firms whereas in Poland, Hungary and Albania firms have to apply to different ministries (sometimes more than one) for their activity specific licenses. It is not just the excessive amount of paper work that accounts for the entrepreneurs’ assessment of this process but, more seriously, the fact that in some countries (such as Albania), the licensing authorities were identified as being particularly obstructive to new businesses—a resistance which could be eased with "side payments" (more on this later).

Given the difficulties associated with registration and licensing procedures, many firms rely on the services of lawyers and other professionals to help speed up the process and smooth the difficulties. The data on the use of professional consultants may be viewed as a proxy for the complexity of the procedures in each country: As Figure 7 shows: the majority of new firms in all countries rely on the use of outside consultants with Hungarian firms showing the highest, and Albanian firms the lowest, levels of reliance.

Another indicator of the complexity of the registration and licensing procedures is the length of time needed for their completion. Figure 8 shows this length of time for firms in our sample and confirms the results of the previous question on the use of consultants—the procedures take the longest in Hungary, with 5.2 months, and the shortest in Albania, with 2 months. The time taken to complete the registration and licensing procedures indeed mirrors the use of professional consultants—the more complicated and lengthier the process, the more widespread is the use of consultants.
It should be pointed out that in Hungary firms can actually start their activities before the
court registration procedure is completed. The long duration of the process, therefore,
does not seriously affect their entry into the market.

As mentioned in the Introduction; the regulations on registration and licensing bestow
control rights on politicians and bureaucrats who may use their position for rent seeking. It is
commonly believed that, in most transition economies, bribes are used to speed up the
registration and licensing procedures. Indeed, as the authors of a recent large scale study of
bribes in transition economies have put fit, the "thicker webs of regulation lend themselves to
greater (potential for) extraction of bribes by bureaucrats" (Johnson et al. 1999, p.10). In
investigating the incidence of bribes in different countries, we could not directly ask the
respondents whether they had paid any bribes to officials involved in the process. Such a
question would have invited inaccurate answers. Instead we asked them: "In your opinion, are
bribes (open or hidden) commonly used to speed up the registration process?" Given the
sensitivity of this issue, we had expected that many respondents would probably not wish to
answer this question. In practice; however, the majority of respondents in all countries
(indeed a large majority in most countries) did have a view about the use of bribes and offered a positive or a negative response. Figure 9 shows the proportion of positive and negative answers to the question, leaving out the "do not know" group.

FIGURE 9. Use of Bribes to Speed Up Registration and Licensing Procedure

![Bar chart showing the proportion of positive and negative responses to the use of bribes in different countries.](image)

It is alarming that the Czech Republic was identified as the country where the highest number of respondents (77%) believed that bribes were used to speed up the process. Albania, with 50%, was the country with the second highest level of positive response. It was also interesting that in Poland, the highest percentage of respondents (54%) gave a negative answer to the question.  

**REAL ESTATE REGULATIONS**

The purchase and lease of commercial real estate was one of the areas which was not fully liberalised in the early transition period. At the beginning of transition, most real estate was owned by municipalities or other state organs and their sale was heavily regulated by legislation and by regulations imposed by municipalities. These laws and regulations were aimed at preventing the sale of real estate at low prices (particularly to foreign individuals and companies) and at keeping a regular source of income for local governments. Although private ownership of buildings (partly by those who have received their former property through restitution and partly by those who have purchased their residence in the privatisation process) has gradually grown in all countries, most new businesses still have to lease their property from a variety of public organisations. These organisations, operating in non-competitive markets, often dictate their own terms to the tenants and thus act as a barrier to their growth. As Figure 10 shows, our sample firms are no exception and the majority of them, in all five countries, have to rent all or part of their premises.

These firms were then asked to identify the problems arising from their tenancy agreement or from the nature of the market for leased properties. Their responses are summarised in Figure 11. Tenancy agreements which enable the owners to increase their rent at short notice was clearly the most frequent problem faced by the tenants, particularly in Albania and Poland. This was followed by the high level of rent resulting from the monopolistic position of the owners (often municipalities or other state institutions) and a shortage of commercial real estate, particularly in Hungary and Poland.
Although real estate regulations have changed gradually since the early days of transition, the majority of our respondents in most countries maintained that these changes had not simplified the procedures, the only exception being Hungary where 49% of respondents thought that these regulations had become less complicated. In Albania, a significant minority (38%) complained of increasing complications of real estate regulations. Figure 12 represents the respondents' view of changes in real estate regulations.

The restricted conditions of the real estate market, and the monopolistic pressure from various levels of government act as important barriers to entry in most transition economies. Governments can, and indeed should, play a more active role in making these markets more competitive by privatising the stock of state owned real estate, reducing the power of rent seeking local governments, and improving the conditions of tenancy agreements faced by new firms.
Labour and employment laws pose problems for new firms in many countries-transition economies being no exceptions.

As Figure 13 shows, a large majority (over three quarters) of the sample firms in Visegrad countries and Lithuania felt that at least some aspect of regulations on labour relation impeded their development. In Albania, a smaller percentage of firms (56%) had problems with these laws-in Albania, not surprisingly, employment regulations have not been widely enforced.

Many observers believe that labour markets in transition economies have retained many features of their socialist past. Employment practices are still highly restrictive; there is a belief that the burden of social and health insurance should fall on the employer alone; it is
expected that wages should automatically rise with inflation; rules governing dismissals are very strict; and, in short, entrepreneurs are implicitly seen as exploiters of their workers. Restrictive labour market conditions impose additional barriers especially for new firms and weaken their competitiveness in relation to established firms. They also create an incentive for firms to operate outside the formal sector. Our results confirm much of these views and provide the policy makers with an opportunity to streamline and improve the conditions governing labour relations.

New firms not only have to familiarise themselves with, and observe, the existing rules regarding employment relations but also have to deal with frequent changes in these rules. Here, our investigation of the nature of changes in employment laws has produced rather mixed results— in Poland and Lithuania, a large majority (64% and 68% respectively) felt that employment regulations have become more complicated since the beginning of transition. In Hungary, 61% of firms believed that regulations have become less complicated. In the other two countries, a large majority (77% and 64%) felt that regulations had not changed much in the period under consideration. Figure 14 shows how changes in labour laws were perceived in different countries.

The response of the sample firms in Albania should not be surprising of course since a new labour law went through their Parliament only in 1998 (six years after the beginning of transition) and, in any case, the provisions of the labour law have been widely disregarded. For example, contrary to the provisions of the labour code, many employees in the private sector do not have a formal written contract with their employers.

In order to highlight the main obstacles posed by labour regulations, we enquired about the firms' views on four specific aspects of these regulations: social and health insurance contributions, dismissal regulations, the minimum wage, and trade union activities. Figure 15 shows the impact of these specific aspects on those firms that had considered labour and employment laws a problem for their development.

**FIGURE 14. The Nature of Changes in Employment Laws**

![Figure 14: The Nature of Changes in Employment Laws](image)

- **Czech Republic**: 18% more complicated, 5% less complicated, 6% not much changed
- **Hungary**: 61% more complicated, 33% not much changed
- **Poland**: 64% more complicated, 27% not much changed
- **Albania**: 64% more complicated, 4% not much changed
- **Lithuania**: 68% more complicated, 30% not much changed

Legend:
- ■ More complicated
- □ Less complicated
- □ Not much changed
While the great majority of those firms that had expressed concern about labour and employment laws highlighted "health and social insurance contributions," followed by "dismissal procedures," only a very small proportion considered the "minimum wage" or "trade union activities" a problem. Contrary to the common wisdom and the long tradition of trade union activities in all former socialist countries, very few respondents considered these activities as a problem (none in Albania and Hungary). This may be partially due to the fact that our sample firms were in general small and private (see Figure 4), thus not attracting much trade union activities which are much more prevalent in large state owned firms. The "minimum wage" was considered a problem by only a tiny minority of firms in Visegrad countries, and by none in Albania. Only in Lithuania 13% of firms expressed some concern about the minimum wage. Although this aspect also appears to contradict the popular belief about the adverse effects of a minimum wage on firms, in reality it may be more due to the way in which firms pay their employees rather than their feelings about a real and effective "minimum wage." In some countries, like Hungary and the Czech Republic, employees of many small firms receive their wages in two parts—a reported portion which is usually about the minimum wage, and an unreported portion paid in cash and thus not subject to deductions for taxes and various contributions. Furthermore, as Table 2 shows, the minimum wage in all five countries is much lower than the average wage (less than half), is not a binding constraint, does not pose a problem for firms, and will not have any adverse effect on employment.

<table>
<thead>
<tr>
<th>Year</th>
<th>Albania</th>
<th>Czech Rep.</th>
<th>Hungary</th>
<th>Lithuania</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>46</td>
<td>25</td>
<td>42</td>
<td>45</td>
<td>41</td>
</tr>
<tr>
<td>1999</td>
<td>50</td>
<td></td>
<td>42</td>
<td></td>
<td>39</td>
</tr>
</tbody>
</table>

Health and social insurance contributions were considered a major problem by almost all Albanian, Hungarian and Polish firms and by a large majority (70%-80%) in the other two countries. Given the very high rates of these contributions (discussed in more detail in the fol-
lowing section), it was not surprising to find such consistent perception across the five countries. Regulations on the dismissal of employees were considered a problem by over two-thirds of firms in the Czech Republic; half in Lithuania and Poland; a quarter in Hungary and only 4% in Albania. The very low figure in Albania is largely due to the absence or non-enforcement of regulations on termination of employment (at the time of our survey). A new "labour code" passed by the Parliament in 1998 has not been fully implemented or enforced yet.

With the exception of Albania, most firms in the sample have had the experience of dismissing employees since their establishment (ranging from 65% in Hungary to 84% in Poland and the Czech Republic and to 86% in Lithuania)-in Albania the proportion was only 36%. The average length of the dismissal proceedings is a good indicator of the legal and procedural difficulties faced by firms who wish to dismiss their employees and the relative significance of this issue for the management. Figure 16 shows the average length of the dismissal proceedings in the five countries:

Given the fact that many employees of small private firms do not have an "employment contract" in Albania, it is not surprising to see that these proceedings take only half a week there, compared with 2.4 weeks in Lithuania, 4.3 weeks in Hungary, 5.1 weeks in Poland and 6.7 weeks in the Czech Republic.

**FISCAL REGULATIONS AFFECTING NEW BUSINESSES**

Taxes and contributions are a major source of complaint by new businesses in all transition economies. Surveys of SMEs in these countries usually highlight the high level of taxation as one of the main obstacles to new business development and a main cause of the growth of the shadow economy. The rates of taxation and threshold levels vary considerably in the five countries under consideration and, in some cases, they are higher than many West European countries. Table 3 shows the rates and levels of the main taxes and social and health insurance contributions in the five countries.

The table highlights, three striking features of the fiscal barriers facing new firms and entrepreneurs. Firstly, the wide variation in tax rates and threshold levels in different countries. The income tax paid by the majority of income earners (the Basic rate) varies widely from 5% (in Albania) to 33% (in Lithuania), with the more advanced countries in the 15-20% range. There is no logic to this wide range and these basic income tax rates-which on the one hand generate an incentive to evade taxes and, on the other hand, result in insufficient revenue for the state. The situation is the same for the high income group (subject to the highest income tax rate) too. While in Hungary, the highest rate of 42% is applied to annual incomes exceeding only $4,000, in the Czech Republic the highest rate of 40% does not come into effect until the income level has reached nearly five times that in Hungary (i.e., $21,000).

**FIGURE 16. Average Length of Dismissal Proceedings**

![Bar chart showing average length of dismissal proceedings in weeks for each country.

Czech Republic: 6.7 weeks
Hungary: 4.3 weeks
Poland: 5.1 weeks
Albania: 0.5 weeks
Lithuania: 2.4 weeks.
### TABLE 3. Taxes and Contributions in Five Transition Economies, 1999a

<table>
<thead>
<tr>
<th>Category</th>
<th>Czech Rep.</th>
<th>Hungary</th>
<th>Poland</th>
<th>Albania</th>
<th>Lithuania</th>
<th>U.K. EU average</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Personal income tax</strong> (basic 15-40% 20-40% 19-40 5-20% 33%b 23-40 20-55 and highest rates, %)</td>
<td>15-40%</td>
<td>20-40%</td>
<td>19-40</td>
<td>5-20%</td>
<td>33%b</td>
<td>23-40</td>
</tr>
<tr>
<td><strong>Threshold level for the $21,000 $4,000 $12,700 $5,240 $640 $43,360 highest rate (annual)</strong></td>
<td>$21,000</td>
<td>$4,000</td>
<td>$12,700</td>
<td>$5,240</td>
<td>$640</td>
<td>$43,360</td>
</tr>
<tr>
<td><strong>VAT (%)</strong></td>
<td>5.22</td>
<td>12.25</td>
<td>7.22c</td>
<td>20</td>
<td>18</td>
<td>17.5</td>
</tr>
<tr>
<td><strong>Threshold level (annual sales)</strong></td>
<td>$88,000</td>
<td>$8,000</td>
<td>$20,500</td>
<td>$36,400</td>
<td>$12,500</td>
<td></td>
</tr>
<tr>
<td><strong>Company tax (on profits) (%)</strong></td>
<td>35</td>
<td>18+23d</td>
<td>34</td>
<td>30</td>
<td>29</td>
<td>31</td>
</tr>
<tr>
<td><strong>Special cases</strong></td>
<td>-</td>
<td>20e</td>
<td>20f</td>
<td>40,50g</td>
<td>14.5h</td>
<td></td>
</tr>
<tr>
<td><strong>Reinvested profit</strong></td>
<td>-</td>
<td>18</td>
<td>17</td>
<td>12</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td><strong>Capital gains</strong></td>
<td>25</td>
<td>10?</td>
<td>34</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td><strong>Social security, health, pension and unemployment contributions (%)</strong></td>
<td>Total: 47.5</td>
<td>48.5i</td>
<td>39.12l</td>
<td>45.9</td>
<td>31</td>
<td>29.9k</td>
</tr>
<tr>
<td><strong>Employer</strong></td>
<td>35</td>
<td>36</td>
<td>20.41l</td>
<td>34.2</td>
<td>30</td>
<td>15.5</td>
</tr>
<tr>
<td><strong>Employee</strong></td>
<td>12.5</td>
<td>12.5</td>
<td>18.71</td>
<td>11.7</td>
<td>1</td>
<td>14.4</td>
</tr>
</tbody>
</table>

**Notes:**

a All dollar figures are based on the August 1999 exchange rates.

b Only one rate after the threshold income of 2,568 Litas (US$640) is reached.

c Pharmaceutical products are subject to a temporary rate of 2%.

d A company's taxable income is taxed at 18%. Furthermore, if a part of profits is distributed to shareholders, an additional tax of 23% is levied on dividend payout. If all profits were reinvested, the tax rate would be just 18%.

e For dividend income. This tax may be claimed back by Hungarian citizens (but not foreigners) in the following year's tax calculations.

f For dividend income.

g In tourism (40%) and foreign off shore oil exploration (50%).
h For tourism (40%) and foreign off shore oil exploration (50%).
i Contributions apply only to the first $1,680 of annual income.

j Until the reform of the social security system on 1 January 1999, employees' remuneration was normally expressed in net terms and it seemed as if the employer was paying all the relevant contributions. Since these reforms, wages and salaries are expressed in gross terms with the employee and employer's shares of contributions clearly identified. The reforms were of course financially neutral and did not increase either the employee's or the employer's contributions. Also, as a part of the reform of the healthcare system, a proportion of an employee's income tax (currently 7.5%) is paid directly to a healthcare fund, supplementing what is paid through the enterprise system.
These figures apply when employees are in an occupational pension scheme; otherwise the contribution is 10% for employers and 10% for employees (20% in total).  
2% of this is unemployment tax and 0.18% special labour tax.

Source: Country figures are compiled by authors, EU average is adapted from Borish and Noel (1996).

In Albania, incomes in excess of $5,240 are subject to 20% while in Lithuania incomes exceeding $640 are subject to the tax rate of 33%. The VAT rates are relatively similar, with the higher rates, which are applied to the great majority of products, ranging from 18 to 25%. But the turnover threshold for the application of VAT varies significantly between countries, ranging from $8,000 in Hungary to $36,400 in Albania and $88,000 in the Czech Republic.

Secondly, the contributions for social security, health, pension; etc., vary widely between countries, with the employers' contribution varying between 20% (in Poland) and 36% (in Hungary) and the employees' contribution ranging from 1% (in Lithuania) and 18.7% (in Poland). The low rate of employees' contributions is largely a reflection of the past practice, that the state (and not the employees) was responsible for health and social security provisions.

The high rates of taxes and contributions have now attracted the attention of Polish and Hungarian governments and steps have been taken to reduce these levels when possible. As Table 4 shows, company taxes have fallen quite significantly in the three leading transition countries, reflecting their governments' recognition of the desirability of a lower tax regime (with its impact on entrepreneurial incentive and reducing the marginal benefits of tax evasion). The situation in Albania and Lithuania has not changed since the beginning of transition.

The third interesting feature of the Table 3 is the very high level of social and health insurance contributions in all countries (except Lithuania) in comparison with the UK and EU average figures. Here, the level ranges from just about 39% in Poland to nearly 48.5% in Hungary. The situation in Hungary is particularly important and may explain why firms declare only a portion, of their employees' wages and pay the remainder under the table. In fact the present situation is a slight improvement on the earlier period when these contributions constituted 54.9% of gross salaries in Hungary. The comparable figures for the UK and the European Union are added to the table to draw attention to the relatively high levels of taxes and contributions in transition economies.

Our investigation of nearly 400 firms in the five countries confirms this broad picture: that the level of taxes and contributions and the complications of relevant regulations constitute a major problem for new businesses-as are the frequent changes in these regulations. The level of taxation, their complications and frequent changes all provide a natural incentive for tax evasion amongst new businesses. Many smaller firms run some parts of their operations in the shadow economy and the size of these activities is often linked to burden and problems of taxation.

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<tbody>
<tr>
<td>Czech Republic</td>
<td>65-75</td>
<td>39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>40</td>
<td>18 + 23a</td>
<td>18 + 23a</td>
<td>18 + 23a</td>
</tr>
<tr>
<td>Poland</td>
<td>40</td>
<td>38</td>
<td>36</td>
<td>34</td>
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<tr>
<td>Albania</td>
<td>30</td>
<td>30</td>
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<tr>
<td>Lithuania</td>
<td>29</td>
<td>29</td>
<td>29</td>
<td>29</td>
</tr>
</tbody>
</table>

*a A company's taxable income is taxed at 18%. Furthermore, if a part of profits is distributed to shareholders, an additional tax of 23% is levied on dividend payouts.

In the previous section it was noted that the high level of "social and health insurance contributions" was the most frequently identified aspect of employment regulations causing problems for companies in the sample. This issue was further emphasised by the respondents when asked about changes in the level of taxes and contributions as well as the frequency of changes in fiscal regulations and their impact on the management time allocated to these issues. These are explored here.

A majority of respondents believed that the level of taxes and contributions paid by them (as a percentage of their revenues) had increased since their establishment—the majority being particularly high (70-88%) in Hungary, Poland and Albania. Figure 17 shows the responses of sample firms to a question regarding changes in the tax burden. Of course, as Table 4 shows, company taxes have been declining in the Czech Republic, Hungary and Poland over the past few years, but the rise in other contributions has overshadowed the reduction in taxes.

In general, managers complain about the excessive tax burden and the frequent changes in regulations governing taxes and contributions. With the exception of the Albanian respondents, a large majority in all other countries (53% to 86%) believed that there had been too many changes in the regulations concerning taxes and contributions.

**FIGURE 17. Changes in Tax Burden**

![Bar chart showing changes in tax burden](image)

* Burden is defined as taxes and contributions as a percentage of revenue.

Furthermore 50-82% of respondents in four countries (excepting Hungary) believed that fiscal regulations had become more complicated. Interestingly in Hungary, a large majority
of respondents (87%) felt that fiscal regulations had become less complicated. This is quite surprising—particularly in the light of the fact that very few respondents in other countries (0-4%) perceived changes in fiscal regulations in this way. The frequency and the nature of changes in fiscal regulations are shown in Figures 18 and 19.

The frequency of changes in fiscal regulations; and their associated complications, result in a "compliance cost" for firms—an increasing portion of management's time being spent on fiscal issues and a greater reliance on outside tax experts and advisors. In our sample, 64-80% of respondents in four countries (Albania being the exception) believed that managerial time devoted to tax and contributions issues had increased since their establishment. Similarly, 60-88% of respondents in all countries indicated that they have, "sometimes" or "often," used outside tax specialists to deal with their fiscal problems. These are shown in Figures 20 and 21.
The last aspect of regulatory influences examined here is the impact of regulations concerning exports and imports on sample firms. The majority of Czech and Polish firms (73% and 63% respectively) did not have any problem with these regulations while about half of the Hungarian and Albanian firms and three-quarters of the Lithuanian firms have had problems with these regulations. Figure 22 shows the impact of foreign trade regulations on sample firms. Lithuanian firms seem to be particularly affected by this factor, with about three-quarters of them experiencing difficulties in this area.

**FIGURE 20. Compliance Costs: Changes in Management Time Spent on Issues Relating to Taxes and Contributions**

![Graph showing changes in management time](image)

**FIGURE 21. Compliance Costs: The Use of Outside Tax Specialists**

![Graph showing use of tax specialists](image)

The small size of the economy and its heavy reliance on international trade makes it particularly sensitive to export-import regulations. But the nature of regulations in this area is also perceived to be highly restrictive.\(^{17}\)

Finally, in order to compare the relative importance of different problems facing new firms, the respondents were asked to express their overall impression of the impact of different fiscal and regulatory impediments to the establishment of new businesses on a 1-5 scale (with 1 indicating a minor difficulty and 5 a major one). In this list we have also included "health and safety" issues. The results are shown in Figure 23.
In four countries, the respondents ranked "high taxes and contributions" as the factor with the strongest impact. In the fifth country (Lithuania), the respondents ranked "exports and imports regulations," closely followed by "high taxes and contributions" as the factors with greatest impact. These results are consistent with responses provided to earlier questions and discussed previously: in the case of Lithuania, we have already pointed out that regulations on exports and imports were perceived as a serious problem area by a majority of respondents:

Having discussed the views of company managers about different barriers to entry, it is important to emphasise the subjective nature of these assessments and the difficulty of comparing the impact of various constraints for different firms and countries. The identification and evaluation of different barriers are based on the subjective evaluation of individual managers and may vary not only from company to company but also from country to country. What one manager may rank as 5, may be ranked by another one only as 4 even if this is supposed to reflect the seriousness of a particular factor. Furthermore, the notion of difficult or easy may vary from one country to another. Cultural factors play an important part in these subjective assessments. One way of reducing the degree of subjectiveness is to examine the "ordinal" aspect of responses (rather than their "cardinal" aspect).

FIGURE 22. Proportions of Firms Having Problems with Regulations on Exports and Imports

In the graph, the percentages of firms facing problems with regulations are shown for Czech Republic, Hungary, Poland, Albania, and Lithuania. The percentages are as follows:

- Czech Republic: 27%
- Hungary: 51%
- Poland: 37%
- Albania: 56%
- Lithuania: 76%

FIGURE 23. The Evaluation of the Impact of Different Rules and Regulations on New Firms

The impact of various impediments is ranked on a 1-5 scale, with 1 indicating a minor difficulty and 5 a major impediment. The impediments include:
- Renting/leasing of premises
- Registration/licensing
- Taxes & contributions
- Export/import regulations
- Health and safety
- Labour laws

*The impact of each impediment is ranked on a 1-5 scale with 1 indicating a minor difficulty and 5 a major impediment.
While it may not be easy to assign a precise number (on a 1-5 scale) to the degree of difficulty of a particular constraint, it is perfectly possible to rank various constraints in their "order" of difficulty or ease. The "ordinal" approach enables us to compare different constraints with each other and amongst different countries. Starting from the six areas considered as barriers in each firm, we assigned a ranking of 1 to 6 in descending order of difficulty (1 to the most serious barrier and 6 to the least important one). These rankings were then averaged for the entire sample to provide one index for each of the six impediments. In this way, excessive reliance on individual managers' subjective evaluation can be avoided. As Figure 24 shows, the regulations on taxes and contributions is by far the most important impediment affecting the establishment of new firms, followed with a big gap, by regulations on foreign trade and on renting and leasing of property.

**FIGURE 24. The Ranking of the Impact of Different Rules and Regulations on New Firms**

*Ranking is based on assigning 1 to the most serious and 6 to the last serious impediment for each firm and averaging them over the entire sample.*

**CONCLUSIONS**

Regulatory and fiscal constraints impede new firm entries in all countries irrespective of the stage of transition they have reached. Although we had expected to find significant differences between the two groups of countries (on the one hand Poland, Hungary and the Czech Republic as the front runners in transition and, on the other hand, Albania and Lithuania as the "latecomers"), we did not find any strong evidence in support of this expectation. In terms of the problems faced by new entries, there are more similarities, than differences, between firms in the two groups of countries.

There are of course differences between the two groups too, often, over issues that new transition economies have not had enough time to deal with yet. In some areas regulations are not affecting entry very much not because the country in question had travelled down the reform path extensively and reduced the cumbersome regulations but because that country
had not introduced effective regulations in that area yet or was not enforcing the existing regulations actively. Albania is a country that stands out in this respect. Employment regulations which are considered an important problem for firms in other countries, do not constitute a serious problem here because employment regulations (particularly the requirement for "employment contracts") are not enforced widely and seriously. Similarly; the absence of adequate financial system regulations, which allowed the high interest-high risk pyramid schemes to operate unhindered before their disastrous collapse in 1997, is another example of the absence (or non-enforcement) of regulations.

A number of areas of regulation were consistently identified by the respondents in five countries as having detrimental effects on entry of new firms The registration and licensing process, particularly the court registration and the obtaining or renewal of activity-specific licenses are examples. At present, new firms have to go to a number of separate places to register with different state authorities in order to be able to conduct their business legally. Much of this can be eliminated with little additional public resources. It is possible to have a "one-stop shop" where new firms and entrepreneurs can complete the registration process in one physical place and on one date. It is also possible to have the new firms to register with courts and to arrange for courts to send the relevant information to the tax, social security, statistical and other offices. This would reduce the new firm's start-up costs significantly.

The issuing of activity specific licenses may also be simplified though this requires more caution. The government has to strike a balance between the need to liberalise the markets and the duty to protect the public by ensuring that certain professions and activities are licensed subject to necessary control and monitoring processes (e.g., the licensing of medical practitioners, food outlets, drug manufacturers, etc.). But it is well established that certain permits and licenses are issued at the behest of interest groups and lobbies and are aimed at restricting the entry of new participants to the particular profession. Since the beginning of transition, the number of areas subject to licensing has in fact increased in most transition economies. It is essential that the government distinguishes between the different motives for the issuing of permits and licenses and abolishes those areas where licensing is not essential for public interest.

The real estate market is another area of concern for new firms. Although a significant minority of new firms own their own premises, the majority do not. The general complaint is that the supply of commercial real estate is limited and that small firms are subjected to frequent rent increase by the owners of their premises. The ability of owners to increase rents at short notice, of course, is directly linked to the short supply of the available commercial property. Given that in most cases the owners are municipalities or other state institutions, the government can indeed make a positive contribution to the resolution of this problem by speeding up the privatisation of the housing stock. In this area, with all the housing stock privatised, Albania is well ahead of other countries. Given that the ownership of real estate provides the municipalities with a regular and significant source of income, the speedy privatisation of the real estate must deal with the thorny question of local government finance too. Clearly, the central government will face a strong opposition to such privatisation efforts from the local governments and their lobby who are the beneficiaries of the present arrangements. But it is exactly such measures which could lead to "depoliticisation" of the lower levels of government and the limiting of their leverage on new businesses.

Fiscal constraints to entry are also universal in transition economies. Amongst the various constraints, taxes and contributions were ranked as the most important problem facing firms in all countries. A glance at tax rates, social and health insurance contributions and tax thresholds in the five countries showed that-in comparison with some of the mature market economies of Europe-these countries are indeed taxed highly and with much variation.
Median level incomes are subject to tax rates varying from 5% to 33% while the threshold at which the highest income tax rates come into effect vary from $640 (in Lithuania) to $21,000 (in the Czech Republic). Similarly, the social and health insurance contributions in three of the five countries (Albania, the Czech Republic and Hungary) are significantly higher than EU rates.

The most important consequence of this state of affairs is the creation of the incentive to evade taxes and to operate some or all of a firm's activities outside the formal economy. This would further reduce government's revenue and its ability to undertake its normal services, including the policing of the informal economy. The resolution of the problem of high tax burden is of course extremely complicated and has to be dealt with in the context of a general restructuring of health, pension, and other social services. Governments in some countries under consideration have attempted to reduce direct taxation in recent years (both personal income tax and company tax), but on the whole the very high levels of contributions have more than cancelled out the effect of these small tax cuts.

A related issue is the high compliance cost faced by all new and small firms. The frequency of changes in fiscal regulations (and their increasing complexity) requires an increasing amount of management time in all countries-a diversion from the normal functions of management and a cost to the whole economy. An increasing number of relatively small firms have to rely on the services of outside tax specialists in order to deal with the complications of tax regulations. The governments in transition economies can, and should; try to simplify the tax procedures and avoid frequent changes in tax rules-a step which may also reduce the incentive to operation in the shadow economy. The Polish government seems to have been the only government in the past two years which has attempted to simplify the tax system-but even then these attempts have been strongly opposed by a variety of political groups and lobbies.

NOTES

1. The attitude of the ruling parties in some countries (e.g., Albania and the Czech Republic) was that all economic activities were legal as long as they were not explicitly forbidden by law. This approach resulted, for example, in financial scandals such as the formation of pyramid schemes in the former and the "tunnelling" of privatisation investment funds by their main shareholders and managers in the latter. Similarly, almost all transition economies suffered from environmental damage caused by the massive, uncontrolled and wholesale import of second-hand cars, many of them not road-worthy, from Western Europe.

2. As Friedman has pointed out the licensing of professionals (doctors and nurses for example) is a mechanism by which the state provides relatively low cost information about the qualification of these professionals for consumers. At the same time, as a barrier to entry of new economic units, this is not an excessively costly barrier. See the discussion of occupational licensing in Friedman (1962), pp. 137-160.

3. On the question of environmental protection, e.g., the Hungarian law was passed only in 1996 while in Albania there is still no law regulating the impact of economic units on the natural environment. As far as financial issues are concerned, Albania and the Czech Republic provide excellent examples of the consequence of a tax regulatory framework. When some of the culprits of the disastrous pyramid schemes in Albania were tried and convicted; it was realised that the existing rules could only impose a maximum of 3 years imprisonment on them, i.e., the country lacked proper rules of the game to hand them punishments in proportion to their crimes. Similarly, in the Czech Republic, the culprits of the tunnelling of investment funds and many other financial irregularities have gone unpunished because of the lack of appropriate rules.
4. In Poland, e.g., the expenditure on the "safety net" was also over-generous in the beginning of transition because the Solidarnosc-based government wanted to protect its supporters from the pains of transformation.

5. Of course, we should not ignore the fact that many new entrepreneurs have accumulated their capital and achieved their early growth thanks to the existence of the grey economy. Some of these entrepreneurs, once reached a large size, moved into the Formal sector (see Kloc 1997 for the evidence of this movement in Poland).

6. For a more detailed study of the barriers to the entry and growth of new firms in individual countries, see Balcerowicz et al. (2000).

7. In Hungary, a small number of our sample firms were established in 1989. These are included with the number of firms established in 1990.

8. As Figure 3 shows, some country samples included a few firms, employing more than 200 in 1995. These Firms were selected for the sample because at the time of interviews their employment levels were below 200. Only in the course of the interview fits was noticed that in 1995 they had higher levels of employment. Given that these were successful Firms that had expanded very rapidly in the early transition period fits was thought that their experience was relevant to the project and that they should be included.

9. In Poland a separate register of commercial companies is kept in each of 49 voivodships. In Hungary it is not necessary for legal persons to produce a criminal record clearance to engage in economic activities (except in some specified activities).

10. In the care of Poland, the above results are confirmed by a recent study of the incidence of bribes in transition economies, covering 300 Polish firms and conducted in late 1997, which found that 20% of managers of these firms believed that bribes are paid to government officials for licenses and other services (Johnson et al. 1999). These authors used the following formula for their question regarding bribes: "what do typical firms in your industry pay to government officials for various services?"—a formula which is very similar to that used in the present paper.

11. In Poland, some entrepreneurs have used their own privately owned property for their business activity (leasing the property to their company) and, in this way, by-passed the monopolistic property market. In Albania too, after the privatisation of housing many ground floor flats were turned into business premises by the owners.


13. The lower rates are usually applied to a small number of products such as children's clothing, pharmaceuticals, etc.

14. In Poland, until 1999, the employees' wages and salaries were negotiated in net terms, thus giving the impression that employees' contributions were zero and that the employers font the whole bill for social and health contributions. This system was changed from the beginning of 1999 (as reflected in Table 3) and employees can now see that they are partially responsible for (and contribute to) their health and social security provisions.

15. In Lithuania, for example, during the months of April and May 1996, 58 new laws and decrees concerning taxes, and 139 regulations concerning business environment came into effect (The State News, various issues, April and May 1996). In Albania, the law concerning profit tax has changed 5 times since 1992, each time resulting in many subsequent changes in relevant government decrees. In Poland there were 107 changes in regulation affecting SMEs between January and August 1997, with the law on company taxation changing 10 times and the law on VAT changing several times. See Polska Fundacja . . . (1998).

16. The increased cost of compliance (in terms of management time and effort) is confirmed by a recent survey of some 1,500 firms in five transition economies which
conclude tht about 20% of managers' time in new private firms is taken up by issues relating to taxes and contributions (Johnson et al. 1999).

17. An earlier study (World Bank 1995) had also found that Lithuanian firms had particular difficulties with export-import regulations.

REFERENCES


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