TRANSITION AND THE PRIVATIZATION PROBLEM

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The real privatization problem in economies trying to make the transition from plan to market is to find a way to privatize that is both economically efficient and politically acceptable. In this paper, I will examine the privatization problem by considering (a) attempts to date in the USSR to privatize (or rather "denationalize") the economy and the futility of those approaches, (b) options that would be both efficient and acceptable, and (c) the role of foreign investment in the privatization process.

Soviet Attempts at Privatization: Reluctant Fumbling

In Soviet discussions and officially promulgated measures, marketization has taken precedence over privatization. This official position on markets and property is understandable: The Motherland of "real socialism" can (in theory at least) accept the market as it did in the time of Lenin's "New Economic Policy," but to accept private property would be an open admission that the whole economic history of communism has been a costly mistake. Therefore, the acceptance of a private property–based economy is—not unexpectedly—the last line of defense of the old order.

Under the circumstances, steps taken so far range from marginally important to misnomers to costly nonsenses. If evaluated together, they leave the impression of a package dictated by ideological prejudices and ignorance.

The development of the new cooperative sector has been widely regarded as a substitute for privatization proper. Cooperatives are a well-known alternative to private ownership. In the West, where the

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cooperative sector has a long history, cooperatives never achieved much in terms of their competitive position vis-à-vis private firms. Even the most sympathetic analysts relegate cooperatives to the margin of economic activity (see Wiles 1977).

It is doubtful whether cooperatives in the USSR will face a different future once private ownership—in its variety of forms—is allowed to compete. Thus, cooperatives can be safely relegated to the margin of any future ownership structure of the USSR economy.

Another development initiated in the second part of the 1980s is leasing. If cooperatives are a solution of little more than marginal usefulness, leasing of state enterprises to workers' collectives is a costly non-solution. Both cooperatives and leasing have been dictated by attempts to stay within a range of collective-based ownership solutions.

Leasing in agriculture is a solution with an even longer history than that of cooperatives. Leasing has been used since the Middle Ages, but it has all but disappeared in the West. The fact that private ownership dominates the agricultural sector points unmistakeably to the inferiority of leasing as an ownership form. Leasing of land in agriculture has its well-known disadvantages: for example, the need to protect land against premature depreciation caused by the leaseholder's careless treatment.[1]

Leasing is perhaps worth serious consideration with respect to the denationalization of *agricultural* assets. But leasing *industrial* assets (factories) to workers' collectives is an exercise in wastefulness of staggering magnitude. Transaction costs in supervising whether proper care is taken by a leaseholder with respect to leased land (and a few other assets) are trivial compared with the enormous transaction costs potentially involved in the monitoring of industrial enterprises that embody a highly complex set of assets. Huge bureaucracies would have to be maintained and there would be little prospect for successful monitoring of enterprise performance given the information assymetry between supervisory state agencies and enterprises.[2] The room for shirking and opportunistic behavior would be enormous (see Jensen and Meckling 1976).

A lease to a collective numbering hundreds or thousands of workers would create the need for an extensive bureaucracy either paid by the workers' collective or chosen from among the workers to

[1]For a general discussion, Eggertsson (1990 and the literature quoted therein).

[2]It should be kept in mind that it is precisely this asymetry that leaves hierarchical bureaucracies of a centrally planned economy at the mercy of state enterprises as far as supervision is concerned.

control opportunistic behavior of co-leaseholders. Leasing to collectives of employees would, thus, generate two layers of agency cost—one at the state level and one at the enterprise level—and possibly result in higher transaction costs than in the case of state ownership pure and simple.

Finally, the Soviets have discussed the possibility of issuing shares by state-owned enterprises. These "shares," however, do not give owners the right to anything more than sharing in the profits of a given enterprise; they are little more than bonds with variable interest paid to their holders. The structure of shareholding does not affect the ownership rights, which remain in the hands of the state.

Consequently, at this point, it seems clear that no privatization in the narrow sense of the word—that is, turning state or other collectively owned assets into private hands—has been occurring in the USSR. In fact, no laws laying down the rules in this respect have been devised, let alone passed by the legislatures.

Privatization Alternatives

If privatization of state assets is to be seriously envisaged, it should be preceded by a thorough evaluation of goals and means through which these goals are to be realized. At the most general level, the goal of privatization is to raise the level of efficiency of the national economy. This general statement, however, is not sufficient to move from the goals stage to the means stage of the evaluation.

As discussions in post-Soviet-type economies such as Poland tend to show, the acceptance of the foregoing may hide more than it reveals. For example, various left-leaning politicians and economists tend to give support to the market economy and even to private ownership in the form of employee share ownership but not to concentrated ownership, for example, to capitalists. Yet it is not some abstract "market economy" that has proved to be the most efficient economic system; rather, it is the capitalist market economy, the one with the thriving capitalist class. As far as investment behavior is concerned, capitalists (people who take capital risk) behave more efficiently than those for whom income from capital (dividends from a few shares held) is a supplement only to income from work. Thus, the acceptance of the efficiency goal of privatization entails the acceptance of the rise of a capitalist class. This rise can be generated in many ways, including privatization.

Another goal of privatization may be the creation of dispersed ownership or "people's capitalism." This goal is generally compatible with efficiency. After all, even owning a few stock shares may

make people aware of the relation between enterprise performance and shareholder worth. An efficiency-reinforcing side effect of share ownership is a greater acceptance of the "rules of the game" that underlie a market economy.

Privatization may also seek the improvement of public finances, such as the reduction of a budget deficit. Given the size of the Soviet Union's budget deficit, short-term considerations of balancing the budget may prevail over long-term considerations of efficiency. Since concentration on improving public finances affects the choice of the means of privatization (as will be shown below), this approach should be avoided.

The choice of means is no less crucial because certain means are compatible only with some goals. For example, if one focuses on the importance of reducing the budget deficit, then one must exclude all means of privatization that envisage free distribution of shares. In such a case, only two paths are open for privatization: (1) the sale of whole enterprises to individuals or groups of individuals or (2) the sale of shares of these enterprises, transformed into joint-stock companies, to the general public. Given the poverty of the population (and not the absence of a capital market), the sale of shares to the population is an approach that extends the process of privatization into the indefinite future. It took Britain's conservative government 11 years to privatize only a handful of state-owned enterprises, comprising about 10 percent of industrial assets. How long would it take to privatize the entire Soviet economy in the same manner? And, let it be added, in the absence of well-developed British financial markets.

The dire need to raise the level of efficiency of the national economy suggests that sale of shares to the general public is a means that will prolong the inefficiency of the Soviet economy by maintaining the dominance of the state sector for decades to come.

The short history of post-Soviet-type economies is also telling in this respect. In Poland the present government has been keen on privatizing along the "classical" British lines. However, after nine months of internal wranglings and pressures from outside, the government has changed its tune and started talking about "accelerated" privatization, that is, one involving the free distribution of assets in one way or another (see "Poland" 1990). In Czechoslovakia government officials responsible for privatization always have been aware of the futility of decades-long privatization through share sales (see Triska 1990). In Hungary the new government has not declared its preferences, but many Hungarian experts have pronounced themselves against free distribution (see Kornai 1990).

If British-style sale of state assets in the form of shares to the general public is not a realistic approach for Soviet-type economies, what options are left to choose from? First, it should be said that a mix of measures is better than a single option. Thus, privatization should start with the offer of sale of small enterprises employing, say, fewer than 100 or 200 persons (as suggested, for example, in Beksiak et al. 1989) to anybody willing to buy them. However, since the absence of a legitimate private sector means that potential buyers may come from black-market operators and the ruling nomenklatura, this option may be less politically acceptable than in Poland or Hungary where the private sector existed for quite some time and expanded recently.

Those who favor accelerated privatization differ with regard to the method of privatization. There are those who prefer free distribution to the entire population (along the lines suggested by Friedman 1976 and Brittan 1984) and those who prefer free distribution to the workers.

Employee share ownership is now pressed strongly in Poland by the left. But even employee share ownership has certain disadvantages that make it less efficient relative to the classical capitalist firm. Employee-owned firms tend to bypass financial markets and, therefore, reduce the efficiency of resource allocation. There are other disadvantages of that solution as well (for example, innovation-related ones).

Employee ownership is not only economically less efficient but also socially inequitable. As pointed out by an old adage, the slogan "mines to the miners, steel mills to the steel-makers" means also "dirt to the dirt-collectors." Obviously, employees in viable capital-intensive enterprises get a lot; those in labor-intensive ones get little; while those working in education, public health, and administration get nothing at all.

Free distribution of shares to the whole population is devoid of such economic and social disadvantages. However, it is much more complicated because wide dispersion of ownership means that the agency costs of controlling managers will be very high (Winiecki 1990a). Broadly distributed ownership, therefore, will require financial institutions, and considerable time may pass before owners concentrate enough shares to control managers.

Janusz Beksiak et al. (1990) have suggested a combination of alternative privatization measures. At the start, 20 percent of the shares would be distributed to employees, and only those shares would have voting rights. The remaining 80 percent of the shares would be controlled by the state, which would receive only the right to

dividends. The state would have no right to intervene in the affairs of the enterprises. Voting rights would attach to state shares only after privatization through sale or free distribution. Owners would be able to control managers from the very start through the board of directors elected by employees/shareholders. Eventually, the stock market would allow ownership to be concentrated; a controlling group from outside the firm's work force would emerge. In the interim, however, control over the management would be ensured. This solution has some negative consequences (see Beksiak and Winiecki 1990), but I think they are smaller than those of alternative solutions to the privatization problem.

In choosing the method of privatization, one must consider the politics of privatization. Privatization is not only an economic issue but also a major political issue. As such, privatization is subject to all the rules of a political game. And the first such rule is that if one wants to push through a certain solution, then one should start making allies. It is easy to point out that "people's capitalism" may win the acceptance of the general public, but in impoverished societies—as those in Eastern Europe—that may be less easy than in the West.

From a political perspective, therefore, free distribution of shares is the best means of privatization since it has the best chance of winning support from the public. Employees of large, capital-intensive enterprises, of course, will often be among those pressing for free distribution to workers rather than for broad-based distribution. But their claim may be countered by appealing to those who will find themselves at a disadvantage if such an option is to prevail. In any case it is advisable to weigh the political balance of power before deciding on the method of privatization.

Some Important Caveats

While we look for the best way to privatize state assets in the Soviet- or post-Soviet-type economy, there are quite a few pitfalls besides those associated with British-style privatization. Those pitfalls will be my main concern in this section of the paper.

The first pitfall is the fascination with state holding companies as a solution to the problem of privatizing large Soviet enterprises. In my view, state holding companies run by managers who are state appointees would be no more efficient than the present state-owned enterprises—and for the same reasons. Without private owners the managers of state holding companies would have the same freedom to pursue goals, other than profitability, as present Soviet managers.

Comparisons with Western state holding companies are misleading. The fact that Western holding companies perform only slightly worse than comparable private firms stems from the fact that Western holding companies are forced to compete with predominantly private firms in the open market. Once a holding company becomes a norm for large enterprises, the environment changes for the worse. Competitive standards will not be maintained or—as in the Soviet case—will not emerge.

Soviet-type economies are characterized by giant enterprises and by a very weak network of small subcontractors. This industrial structure is much less flexible and less efficient than an economy where the size structure of firms follows a more normal pattern. However, the existence of large firms should not be seen as a deterrent to privatization. Poland, Hungary, and Czechoslovakia all have embarked on privatization from an industrial structure similar to that of the Soviet Union. Size is not a problem in itself.

There are two ways of improving the size structure of a Soviet-type economy. The first is "privatization from below," that is, the creation of a legal framework that allows private enterprises to emerge with a minimum of paperwork. Once the legal framework is in place, an institutional framework supporting the expansion of the private sector should be established. The second (complementary) way is through government fiat. There are some obvious cases where giant enterprises were created for the convenience of central planners, and there are no technological or other economic reasons for their continued existence. These enterprises may be broken up by decree (as was done in Hungary).

But there is another, again complementary, way of affecting the size structure of the economy—"from above." Bureaucratic knowledge is always limited, so it is better to give economic units within existing state enterprises the right to become independent enterprises and, subsequently, to be privatized. This right should be given at a preliminary stage of the agreed-upon privatization method(s).

Moreover, it is a known feature of a Soviet-type economy that state enterprises tried to be as self-sufficient as possible under the conditions of supply uncertainty and soft-budget constraint (Winiecki 1988). As a result, these enterprises have a lot of specialized units that are not related to their production profile. Many of these could also become small- or medium-sized firms in their own right and serve a variety of customers.

Another pitfall, related to the fascination with form without regard for substance (as in the case of state holding companies), is what I have called "playing at the stock market" (Winiecki 1990b). It is

possible that those who prefer to maintain the dominance of state ownership—through state holding companies or any similar device—will, nonetheless, try to create the paraphernalia of the market economy. This effort could result in attempts to transform state-owned enterprises into state-owned, joint-stock companies, which would be allowed to participate in the newly established stock market.

Since bureaucrats appointed to run state holding companies or other state-owned constructs risk no capital of their own, their stock market behavior must differ from that of real private firms. There is a world of difference between the shareholder who uses his or her own knowledge, or hires a specialist to play the stockmarket with his or her own money, and the bureaucrat who risks somebody else's money in the game. In such circumstances nearly everything may look attractive, but the result would be overinvestment and disequilibrium as in the past. The stock market with players who are not penalized for failure by losing their own money is a sham—and a destabilizing one at that.

Another pitfall is to believe that privatization solves all problems. Well-assigned property rights are crucial for the efficient performance of the economy but other conditions, such as competition, also matter. Private monopoly is somewhat better than state monopoly because it is not protected by the power of the state, but it is not the best solution.

In some areas competition from abroad, which comes with the opening of the economy to the outside world, will put pressure on domestic monopolies (as in the case of tradeable goods). But there are areas where domestic competition will be increasing very slowly while foreign competition will be absent. In such areas special measures combined with privatization should be applied.

As an example, the average construction firm in the United States employs 10 to 12 people compared with over 700 people in Poland, and probably even more in the Soviet Union. Thus, in Soviet-type economies, regional construction markets are dominated by monopolists or oligopolists dictating their conditions to their clients. In this sector a well-designed way of breaking up these giants should be combined with privatization.

Another example is transportation in the retail and wholesale trade sectors. Given the bureaucratic convenience of centralization, all post-Soviet-type economies usually have just one transport enterprise for the whole retail trade sector in a city or locality. Thus, even the privatization of shops would not be sufficient for the healthy development of that sector, since small shopkeepers would face the

strong monopolist supplier of transport services for quite some time and would distort the pattern of profitability in that sector. Cases such as these abound.

A final pitfall is that of underestimating the role of the time factor. Reformers tend to forget that even if it looks more efficient to undertake some measures in a certain sequence, reformers will be forced to act differently because of the pressure of time. The most often-harbored illusion is that it is possible to design, legislate, and implement privatization before stabilizing and liberalizing the economy. It is argued that the economy would adjust better to new, market-type conditions if it already were privatized. Accordingly, the costs of transition will be lower.

However, decisionmakers rarely if ever have all the time they would like to have. Transition to the market system is usually attempted under the conditions of quite large and growing disequilibrium. Continuation of past trends may cost more than starting stabilization, liberalization, and privatization almost simultaneously. The situation in all East European countries has not been the same in this respect. Poland and Czechoslovakia are contrasting examples. New governments took over at the time of deep and growing disequilibrium and accelerating inflation, which toward the end of the year bordered on hyperinflation. It was obvious that no systemic change would be successful without simultaneous stabilization of the economy.

Therefore, all aspects of change had to be tackled at once: stabilization and liberalization coupled with the beginning of privatization and demonopolization. (The fact that the Polish government failed to tackle privatization and demonopolization properly is an error different from that of wrongly sequencing transition measures.) Czechoslovakia has been displaying a much lower degree of disequilibrium and consequently could afford some preliminary attempts at improving the structure of the economy before stabilization and liberalization. But given the scale of disequilibrium in the USSR, any room for maneuver in this respect seems to be almost as narrow as it was in Poland at the end of 1989.

The Role of Foreign Investment in the Transition Process

There has been and still is a widespread belief among decisionmakers that foreign investment is likely to bring an important positive contribution to the transition from a Soviet-type to a market-type economy. Another belief is that a law on foreign investment that

offers generous incentives will encourage foreign investment, improve industrial structure, improve product quality, and increase hard currency reserves. Such an outcome, however, is highly unlikely. I do not mean that foreign investment is not beneficial for a host country: On the contrary, it undoubtedly is. What I mean is something usually overlooked by those who do not study the subject thoroughly.

It should be realized that foreign investment usually comes in significant quantity only when liberalization has already taken place and the economy displays signs of stability. Currency convertibility and a stable legal framework are especially valued by potential investors (much more so than incentives that can be changed overnight in the unstable regulatory environment). Therefore, foreign investment should be seen as a sign of success of the transition to a more liberal market order that has already taken place, rather than as an expression of hope in the transition that has barely begun.

In small, post-Soviet-type economies (such as Poland, Czechoslovakia, and Hungary) or in the USSR, large-scale foreign investment in manufacturing is highly unlikely at an early date. Foreign investment is not a substitute for a given country's own transition effort. Rather, is a complement—and one coming at later rather than earlier stages of the transition to the market. Moreover, what is true of direct foreign investment is even more true with respect to buying into domestic joint-stock companies where a relatively smoothly functioning stock market is another requirement.

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