The Tunnel at the End of the Light: Privatization in Eastern Europe

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I. Introduction

In Eastern Europe, the collapse of Communism created an opportunity for the victims of one failed utopian ideology to find another. It did not take them very long.

The evaporating Soviet armies and their local apparatchiks left an ideological vacuum that was quickly filled by a remarkable outpouring of ideas on how to spread American-style Capitalism into the former Second World. Legions of Western advisers arrived in the wake of the departing Soviet troops to translate the goals of political democracy and a market economy into an action agenda: "Democracy" translated quickly into elections; "a market economy," into Privatization.

As in many hurried translations, the bare essentials were grasped, but much was missed. Elections are essential to democracy, but functioning democracies are built on much more than just elections -- even "fair and honest" ones. And private ownership, especially share ownership of large companies (and the capital markets to trade those shares), is but one element of a modern market economy.

The exciting, and relatively straight-forward questions of how, and how fast, to privatize state assets and to free trade dominated discussion, both within Eastern Europe and in the growing ranks of Western advisers, consultants, commentators, and fortune seekers. Privatization, in particular, assumed special significance. The conventional wisdom was that Communist firms produced inappropriate, low quality goods at exorbitant costs because state ownership of industry distorted managerial and worker incentives. The generally poor performance of state industries throughout the Third World reinforced the impression that the state and the market don't mix. The main objective of East European economic planners and their Western advisers became "Getting the state out."

The fate of small enterprises like shops, restaurants, small landholding, or farms was never at issue. Everyone agreed that small-scale privatization take place expeditiously. Putting small business in the hands of self-interested private citizens -- "the natural owners" -- seemed the best way to energize private sector growth, especially in service-related industries. Encouraging small scale, private ownership also appeared likely to aid the growth of an entrepreneurial class and a capitalist ethic. It was Schumpeter, after all, who explained that the active small capitalist, the artisan, the proprietor, and not the renter or petty shareholder, who will go to the barricades to defend his property and the system that gives it value to him.[1] And in Eastern Europe, common sense dictated that the New System would need all the avid supporters it could get, and it would need them quickly. The early returns on these hypotheses have been promising. Spurred on by liberal small privatization laws and by the spontaneous opening of new enterprises, Eastern Europe, especially Poland and Hungary, has experienced a boom in small business activity.[2]

It was the fate of the huge and uncompetitive enterprises employing thousands of workers that posed the troubling dilemma.[3] Ideally, in the spirit of radical reform, these relics of a failed era should be condemned and closed. They would then be replaced by lean, competitive firms, not necessarily in the same product lines, but better aligned with the countries' revealed comparative advantage. Social and political reality, however, made this choice quite impossible. What were the options?

Most experts considered only one alternative: privatization. The ensuing debates reduced to second-tier issues, namely, how to transfer assets to the private sector, which assets should be privatized, who -- foreigners, corporations, ex-Communists, ethnic groups, black marketers, former owners -- should be allowed to obtain assets, and how fast should privatization take place. But not whether to privatize.[4]

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[1] Joseph Schumpeter, *Capitalism, Socialism, and Democracy*, Part I., London: Allen and Unwin, 1943.

[2] For an extensive discussion of new, small business activity, including 1991 data, in Hungary, Czechoslovakia, and Poland, see Simon Johnson, "Private Business in Eastern Europe," Presented at the Conference in Eastern Europe for the National Bureau of Economic Research, Inc., Cambridge, Massachusetts, February 26-29, 1992. For a focus on entrepreneurial activity in Czechoslovakia, see Judith Brandsma, "Entrepreneurial Development in Czechoslovakia," prepared for the OECD conference on Training for Entrepreneurship, Prague, October 10, 1991.

[3] Hughes and Hare calculated that taking into account the poor quality of East European products, manufacturing in Czechoslovakia produced a negative value added share of 34%, in Hungary 35.5%, and Poland 38.9% in 1991. "Competitiveness and Industrial Restructuring in Czechoslovakia, Hungary, and Poland," 1991, cited in Sanjay Dhar, "Public Enterprise Restructuring: Achilles' Heel of the Reform Process," *Transition*, Volume 3, Number 3, March 1992, pp. 6-8.

[4] A cottage industry has grown up around privatization in Eastern Europe. The contours of the debate can be captured in the following selections: Ronald I. McKinnon, 1991, *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, Baltimore, Maryland: Johns Hopkins University Press. Ja'nos Kornai, 1990, *The Road to a Free Economy,* New York: W. W. Norton. Manuel Hinds, April 1990, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," *World Bank Discussion Paper*, Manuel Hinds and Gerhard Pohl, April 1991, "Going to Market: Privatization in Central and Eastern Europe," Paper presented at the World Bank/Treuhandanstalt Seminar on Privatization in East Germany and Eastern Europe, Berlin, May 6-7, 1991, Oliver Blanchard, Rudiger Dornbusch, Paul Krugman, Richard Layard, and Laurence Summers, 1991, *Reform in Eastern Europe*, Cambridge, Mass: MIT Press David Ellerman, Ales^ Vahc^ic^ and Tea Petrin, "Privatization Controversies East and West," *Communist Economies and Economic Transformation*, Volume 3, Number 3, 1991, pp. 283-298, Horst Kern and Charles F. Sable, "Between Pillar and Post: Reflections on the Treuhand's Uncertainty About What to Say Next," Conference on the Treuhandanstalt, Harvard University, November 1991. David Stark, "Privatization in Hungary: From Plan to Market or from Plan to Clan?" *East*

Of those issues, the "how fast" question assumed pivotal importance. In many eyes, especially Western ones, delay risked permitting the individuals or groups who stood to lose the most during privatization -- old line bureaucrats, and the managers and workers of state enterprises -- to undermine the privatization process, thereby jeopardizing the transition to a market economy.[5] According to Jeffrey Sachs,

> "...the need to accelerate privatization in Eastern Europe is the paramount economic policy issue facing the region. If there is no breakthrough in privatization in large enterprises in the near future the entire process could be stalled for political and social reasons for years to come, with dire consequences for the reforming economies of the region."[6]

The Economist agreed, calling "the growing acceptance of ... gradualism ... the greatest peril now facing the countries of Eastern Europe."[7]

As those favoring rapid privatization expected, a school of "gradualists" did emerge to advocate slower methods of privatization.[8] The gradualists contended that the short run costs of rapid privatization would overwhelm any conceivable long-term benefit. Long accustomed to the protection of the state, the newly privatized companies would not be able to survive in a competitive market environment. The structures of both supply and demand for these large firms had been shattered; the industrial linkages between Eastern Europe and the former Soviet republics were severed. Politics suddenly separated firms from their customers the way the movement of rivers into new channels left medieval entrepots high and dry on silted streams. Corporate failings resulting from sudden privatization would result in extensive layoffs, massive bankruptcies and ultimately, social unrest. In a climate of chaos, the state would eventually have to support the failing enterprises, one way or another.

European Politics and Societies, vol 4, no. 3, 1990, p. 351-392, David Stark, "Path Dependency and Privatization Strategies in East-Central Europe," East *European Politics and Societies*, vol 6, no. 1, 1992 (Forthcoming), pp. 17-51. For a discussion of reprivatization in East Europe see Andrew Schwartz and Laura D'Andrea Tyson, "Reprivatization in Eastern Europe: Roundtable Report," in Andrea Bohm and Vladimir Kreacic, *Reprivatization in Eastern Europe*, World Bank (Forthcoming).

[5] See Schwartz, Tyson, op. cit., p. 1.

[6] Jeffrey Sachs *Accelerating Privatization in Eastern Europe: The Case of Poland*, World Bank Annual Conference on Development Economics, April 25 and 26, 1991, p. 1.

[7] Economist, "Survey of Business in Eastern Europe," September 21, 1991, p. 5.

[8] The dichotomy between radical capitalists and gradualists oversimplifies the debate somewhat, though the thrust of the argument remains intact. For instance, Ost divides the gradualists into two factions. One, the Populist critique aims to minimize the social costs of privatization by warning that quick integration of Eastern Europe into the world economy increases the likelihood that the region will be pauper, not equal to the West. Two, the social democratic (usually consisting of ex-Communists) approach, emphasizes the importance of worker participation in transforming corporate ownership, noting the rise of post-Fordist techniques of production. David Ost, "The Crisis of Liberalism in Poland," *Telos*, Fall 1991, #89, p. 93. [85-94]

Structure alone dictated an active economic role for the state. A heritage of monopoly structures would mean a future of regulation. Who would regulate monopoly and oligopoly industries? Who would oversee the subsidization of the losers, and the reemployment of masses of workers? Who would oversee international trade and economize foreign exchange, as West European governments found they had to after WW II?

One could add to this prudent litany that private owners could not operate alone in an environment of open trade. The experience of East German industries, the best of the East European bunch, provides a chilling example; they immediately and completely lost their home market to goods from western Germany. Sooner or later, and probably sooner, the government would have to limit or at least filter imports.

Finally, gradualists argued that the absence of credible capitalist or democratic institutions exacerbated the risks of rapid privatization. Such essential preconditions for modern capitalist economies as an established legal system or tax code, financial institutions, and effective capital markets did not yet exist. These shortcomings increased the odds that a "big bang in ownership" would turn into a "big bust."

Could the fragile democratic governments of the region cope with the fallout from widespread company closings? Probably not, argue the gradualists. Privatization's short run risks would threaten a political backlash endangering not only the economic transformation process but also the future of democracy in the region. For their part, the advocates of rapid privatization, or "radical capitalists," generally concede the short run risks, but contend that the long run requisites for economic development -- for example, private ownership -- outweigh short term expediencies.

Basic questions about the significance of private ownership underlie the debate between the gradualists and the radical capitalists. Is private ownership of large enterprises, as its champions proclaim, essential for economic development? In the absence of credible market institutions, is private ownership likely to provide the necessary incentives for manufacturing innovation and efficiency for the former Communist countries to compete on world markets? Only by evaluating the impact of differential ownership structures, can one evaluate rapid privatization's short run risks.

This essay supports the gradualist position in East Europe by questioning the tight linkage assumed between private ownership of big enterprises and economic growth both in general and especially within the region. The discussion incorporates four claims:

1) Privatizing ownership will not, by itself, make large, uncompetitive firms operate efficiently and creatively. Private ownership only makes sense in the context of already established capitalist firms -- which don't yet exist in Eastern Europe. The fundamental challenge for would-be East European capitalists is the creation of competitive market firms from the state enterprises of the command economies, a process that won't occur quickly or painlessly. Large capitalist firms need capabilities in pricing, accounting, legal matters, marketing, and advertising in addition to the establishment of productive incentives. In conjunction with establishing private active ownership must come firm-creation. Moreover, firms don't exist in an institutional vacuum. The character and eventual success of capitalist firms relies on domestic (and sometimes, international) structures of law, finance, regulation, and industry. "Private ownership," even in the Western context, can be meaningfully considered only in the context of embedded socio-economic institutions;
2) Eastern Europe is an unsuitable candidate for rapid privatization because of its minimal recent experience with capitalism and because critical linkages between firms, between suppliers and users, between firms and their traditional markets, have been politically severed. Recreating such international networks will take substantial time; these nations are too small to substitute domestic linkages for them. It will also take time to build complementary political and economic institutions, including the development of a "capitalist ethos." Erecting a system of domestic finance with efficient capital markets is but one important example of such needed institutions. Absent international industrial networks and those supporting socio-economic institutions, large-scale privatizations will not produce viable private firms;
3) The state will play the major role in industrial development in Eastern Europe and remain the biggest owner of large industrial assets irrespective of the chosen privatization strategy. The vulnerability of state industry allows no other alternative. But, the choice of a privatization strategy is not nugatory: it will be important in determining the precise role that the state will play; and,

4) There are reasonable alternatives to simple private ownership of East European large enterprises. They should be explored. The creation of an honest and effective public administration -- not the privatization of uncompetitive giant firms -- is the key step towards the creation of a successful capitalistic market system, and a functioning democracy, in Eastern Europe.

II. Ownership as Ideology/Ownership as Institutional Complexity

Capitalism entered Eastern Europe to fill an ideological void. Mostly it was Fundamentalist Capitalism that poured in -- the universal solution that all could understand: free prices; free trade; and, privatize. It was simple and intense, a formula for action when fast and fundamental action was clearly needed. It quickly assumed the contours of the intellectually and emotionally empty space it filled: it functioned as an ideology. In Czechoslovakia, the observation that "`the leading role of the market' has simply been substituted wholesale for what was once `the leading role of the party'"[9] captured the ideological role the new thinking assumed. Yet, like the ideology that preceded it, capitalism in its idealized form -- with pure prices, free trade, and private owners -- makes more sense as myth than as reality, myth in the Sorelian sense of the term: "A vague association of motivating images."[10]

In spreading their gospel of economic progress, radical capitalists oversimplify notions of private ownership (as well as pure trade and free trade) and pay insufficient attention to the integrated development of institutions in specific states and times; radical capitalists neglect history. Only "economic theory" enters the stage. This was, in part due to the simple fact that most of these advisers are young, know little history, but are quite good with economic models. It is also due to the fact that any remotely appropriate historical experience – such as Europe after WWI or WWII -- pointed in a quite different direction.

Radical capitalists insist that only a system of privately-owned firms linked together by markets provides the right incentives and the right constraints, a set of signals that compel and restrain action that are all aligned towards social dynamism and allocative optimality. Moreover, market signals are prompt and unrelenting. Adaptation is fast and permanent. Planning systems are cumbersome and slow, adaptation is slow and uncertain.[11] For that reason, as well as the

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[9] *New York Times*, "East Bloc Treads Water in an Ocean of Lethargy," April 18, 1992, p. Committee of the Congress of the A6.
[10] Sorel, *Le Mythe de la Greve Generale*

dynamics of selection under such a system,[12] private owners may be better managers than the state.

Private firms are also much more likely to be innovative and increase efficiency given incentives derived from profit maximization rather than plan fulfillment; companies that do not produce quality products at competitive prices go out of business in market economies. Also, private owners have a stake in choosing the most efficient allocation of capital, whereas the state planner may have other motivations, such as maximizing employment or encouraging the development of an industrial sector that may be uncompetitive on world markets. One of the impressive aesthetics of capitalism is the perfect match between efficiency in capital formation and efficiency in production.[13] Moreover, newly privatized industries are likely to attract foreign investors -- the main sources of modern technology and management skills -- more readily than state counterparts. Finally, the competition induced from privatization might eventually result in the downsizing of large, uneconomic monopolies into more productively sized companies. At first glance, it is hard not to agree with the radical capitalists: private firms, even very big ones, are best, wherever and whenever.

There are two problems, however. First, simple-minded notions of private ownership structures obscure issues of control and incentives in modern capitalist economies. It is naive to reduce private ownership in modern industrial economies to a set of entrepreneurs with the authority and the skills to manage large corporations. In practice, modern private ownership is a complex tangle of rights, obligations, warrants, leasing agreements and shares. Actual control of a company depends not only on the distribution of ownership, but on the specific corporate structure. For instance, ownership in many large American companies is divided among shareholders owning preferred and common stock. Others may own convertible bonds or warrants. Yet, the ability of one owner to influence corporate behavior will differ from another depending on the rights conferred by a particular security. For instance, in many cases preferred shareholders may not vote at shareholder meetings, while most common shareholders can. Both categories of shareholders are considered owners. Sometimes even major shareholders of voting

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[11] All of this is best set out in Schumpeter, op. cit.

[12] Ibid.

[13] For a transaction-cost analysis relating the structure of ownership with investment incentives in Eastern Europe, see Oliver Williamson [1991], "Private Ownership and the Capital Market," Prepared for a conference on "Privatization" at the Kiel Institute of World Economics, September 9-10, 1991. Supporting privatization, Williamson argues that "all assets, including capital, require an advocate, and private property is the only `advocate for capital' [See Hinds, 1990] that is both broadly-based and effective." (Williamson, p. 1)

stock cannot influence corporate policy, as many American investors discovered in the 1980's to their chagrin. At that time, some management teams opted to swallow excessive debt ("poison pills") to block takeover attempts that would have netted the shareholders big returns, but would have cost managers their jobs. At other times, owners of firms -- especially those with large debt obligations --may share or perhaps cede control to financiers.[14] Evidence of corporate behavior derived from complex ownership structures already is appearing in Eastern Europe. In contemporary Hungary, David Stark reports that "some banks are beginning to act like owners -- demanding dividends from the KFTs [limited liability companies] and RTs [joint stock companies] affiliated with state enterprises."[15]

Second, economic institutions mediate the impact of ownership incentives.[16] Consider the horizon problem. Should a manager invest to stimulate his bottom line for the next quarter, or should he invest in research and development for the future? The answer depends on the institutional relationships among economic actors. In Germany, for instance, banks exercise ownership functions disproportionate to their actual equity holdings. Some analysts attribute the long-term horizon of German corporate planning to the oversight function of German banks that have an interest in encouraging the long-term stable economic growth of domestic firms. This also accounts for the efforts of German banks to block foreign companies from obtaining equity in major German companies.

In France, as in Japan, for more than a generation after the Second World War, capital markets were not price driven: to an important extent, capital was allocated administratively, less by price (as in the proposed capital markets for Eastern Europe) than by a centralized system of priority allocative categories.[17]

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[14] The problem according to Ellerman et. al., is "Since equity ownership in a public corporation is dissipated over a broad and ill-defined group of shareholders, the top managers together with their board of directors have `power without property.'" Ellerman et. al., op. cit., p. 283. They also observe that "[T]here are remarkable similarities between the state and socially-owned firms of socialism and the public corporations of capitalism." (p. 283)

[15] Stark, "Path Dependency and Privatization Strategies in East Central Europe, p. 31. For a discussion of the increasingly complex nature of Hungarian ownership relations, especially the growing crossholding among firms, private and state see the section entitled "Institutional Cross-ownership in Hungary," in this article, pp. 25-32.

[16] A discussion of the horizon problem broken down by ownership type appears in Jan Winiecki, "Theoretical Arguments for Privatization," *Communist Economies and Economic Transformation*, Volume 3, Number 4, 1991, pp. 399-414.

[17] Stephen S. Cohen, James K. Galbraith, and John Zysman, in *Monetary, Selected Credit Policy and Industrial Policy in France, West Germany, Britain and Sweden*, Joint Economic United States, June 26, 1981. See also, John Zysman, *Governments, Markets, and Growth*, Ithaca: Cornell University Press, 1983.

In Japan, the most successful case ever of rapid development, ownership is of course "private," but only if one defines "private" as meaning not owned by the state. But interlocking shareholding and finance within keiretsu created something far removed from the simple ownership model of the radical capitalists. Keiretsu have no obvious analogy in the rest of the First World. Banks, trading companies, and the state bureaucracy have strong incentives to monitor management in the large Japanese companies. The long-term outlook characteristic of Japanese firms is widely attributed to structural interdependence of these different institutions. Who owns Mitsubishi? Perhaps the most accurate functional answer is "Mitsubishi owns Mitsubishi."

In the United States, on the other hand, owners of large chunks of corporate stock are typically financial intermediaries like mutual funds or pension funds.[18] Since transaction costs are minimal in US markets and the availability of investment options abundant it is easier for holders of financial assets to exit (by selling their interest) rather than exercise voice (by trying to improve management).[19] This system encourages American management to produce a good bottom line (and pay out high dividends) to satisfy investors who are likely to have a short time horizon rather than invest in research and development that may prove more beneficial over the long haul.

Ownership structure is an important element in modern capitalism, but it is only one of many institutions that influence corporate behavior and performance. The horizon problem highlights one of many aspects of those differences. Depending upon the institutional context private ownership takes substantially different forms and functions. Ultimately, it has many different meanings. There is more than one variety of capitalism.

III. Structural Constraints: Turning to the Eastern European Case

Just as it is dangerous to apply narrowly naive concepts of capitalist institutions to Eastern Europe, so it is dangerous to generalize about this region and apply a single set of institutions and a single strategy across the different countries. Even a passing acquaintance with Eastern Europe reveals countries with different political systems, legal traditions, ownership patterns, educational levels, industrial structures, languages, ethnic cleavages, religions and population sizes. It is little wonder that of the four Eastern European countries most actively

[18] Mutual funds or pension funds in the American context are very different animals from those mutual funds envisioned in Eastern Europe, or in particular, in Poland.
[19] See Albert O. Hirschman, *Exit, Voice, and Loyalty*, Cambridge: Harvard University Press, 1970.

engaged in privatization -- Czechoslovakia, Poland, Hungary, Slovenia[20] -- each has a different privatization strategy. Nonetheless, the demise of Communism left a legacy common to each state: to wit, experience with the plan and inefficient centralized state enterprises coupled with inexperience with capitalist institutions.[21] This legacy constrains the prospects for rapid privatization in the region.

There are at least eight interrelated sets of common problems certain to complicate both privatization and the construction of effective institutions throughout Eastern Europe.[22]

(1) Shortage of entrepreneurial experience. More than four decades of Communist rule in Eastern Europe have produced a managerial class unequipped to produce for a capitalist market, not to speak of the entrepreneurial effort implied by the complex restructuring necessary for dynamic growth. Most of the market experience in the region comes from the "Second Economy," and journalistic accounts of black market ingenuity aside, it is dubious that such experience will translate into competent large company owners or factory managers. Besides the petty black marketeers, the other likely new ownership strata is either going to be those who made money illegally -- like big-time marketers or corrupt bureaucrats -- or most likely both, working together as they always have.[23] They would be the ones to split up existing enterprises into their valuable and potentially negative parts, shift excess labor across those parts, maintain their control of the good bits, and benefit from a substantial capital gain at the moment of privatization: millionaires, in one quick shot, no matter how well or badly the enterprise would then perform. Furthermore, where assets would be auctioned off to the highest bidder, only these networks of officials and plant managers, with their underground allies -- most often called, locally, "the Mafia" -- would have the cash to bid. This potential was not lost on some of the more sophisticated foreign advisers: bars in foreigners-only hotels were filled with IMF and World Bank officials

[20] Eastern Germany could be added to this list, but its incorporation into the German state distinguishes it from the other cases.

[21] For instance, Poland plans a mass privatization scheme open to all citizens, entitling them to ownership of shares of mutual funds; Czechoslovakia has embarked on a voucher scheme which entitles nationals to purchase vouchers in individual firms or mutual funds; Hungary is using a mix of programs, most recently emphasizing the sale of enterprises to financially sound investors based on review by private consultants; and Slovenia is intending to sell off its industries to the highest bidder. See Country Privatization Papers from Second CEEPN Annual Conference on Privatization in Central and Eastern Europe, November 29-30, 1991 in Vienna.

[22] This is, of course, only a partial listing. A more comprehensive roster of problems includes macroeconomic stabilization, the lack of administrative capability, ambiguous prior ownership structures, and environmental problems.

[23] Arcadi Vaksberg, *La Mafia Russe*, Translated from the Russian, Paris, 1992.

explaining how the late medieval capitalists in Europe were considered, in their time, to be criminal elements; and look at the winners of the American bootlegging wars; they have now become solid, corporate capitalists. As it invariably did, privatization and legalization would, eventually, transform the Eastern European criminal mafias into normal organizations -- unless, of course, the Southern Italian model reasserted itself.

(2) Shortage of companies ready for a market economy. Many enterprises are burdened with obsolete technology and a poorly trained work force.[24] Other enterprises are encumbered by staggering amounts of debt. Much of the borrowing was the result of irresponsible management of state finances rather than company mismanagement. State enterprises were a convenient receptacle to stash government debt.[25] Recognizing the inevitability of many large enterprises, Hungary, Czechoslovakia, and Poland have decided to implement privatization slowly; thus far, none of the countries has privatized as much as 10% of the large state enterprises.[26] Even the Treuhand -- despite a DM100 billion infusion of capital from western to eastern Germany[27] -- has only privatized about half of the eastern German industries to date; 1.6 million workers remain employed under Treuhand jurisdiction.[28] Despite its ferocious determination to the contrary, it would not be surprising if the Treuhand found itself slowly transformed into a new German version of Italy's much maligned I.R.I. (the giant state holding company).

(3) Shortage of domestic capital. The previous regimes left the economies virtually without savings.[29] The rebuilding of the industrial capacity in the region will have relied on only small contributions from the accumulated savings of the domestic population. Newly privatized firms will need to rely on debt financing from domestic banks or from institutions

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[24] The problem may not be the quality of training, but the type of training. The specific skills of an Eastern worker must fit with Western production methods. One manifestation of this problem is the difficulty that very highly trained East Bloc mathematicians are having in getting jobs in the US computer industry. These specialists are highly experienced, yet not familiar with Western operating systems. As a result, it is hard for them to get jobs; they need to be retrained--an expensive and time-consuming process for a perspective employer.

[25] See Jan Vanous, "Near-Term Prospects for Economic Reform in Eastern Europe," Conference Paper, World Bank Annual Conference on Development Economics, April 25 and 26, 1991.

[26] Johnson, op. cit., Table 12.

[27] Rudiger Dornbusch and Holger C. Wolff, "Eastern German Reconstruction," Paper presented at Conference on Transition in Eastern Europe, Cambridge, Mass., February 26-29, 1992, p. 1.

[28] Figures are as of December 31, 1991, from Fact Sheet, Treuhandanstalt New York Office, January 7, 1992. Nearly 5000 out of 10,500 have been sold.

[29] There is also a problem with foreign debt though countries' exposures differ. As of 1/91: Poland--$11 billion, Czechoslovakia--$6.7 billion, Hungary--$19.5 billion, Yugoslavia (including Slovenia and Croatia)--$7.5 billion. Source: Coopers & Lybrandt, Doing Business in Eastern Europe and the Soviet Union, Washington: Coopers & Lybrandt, 1991, pp. 80-81.

based abroad. Yet, no East European government has an established banking system ready to make the necessary loan commitments. Moreover, real and/or nominal rates are high and credit is generally very tight throughout the region. Loans are very difficult to come by.[30] The major source of capital is likely to remain the state, or in very selected circumstances, foreigners.

The newly privatized firms, striving to become competitive, will not be the only large claimants on the small capital pool. Indeed, they will most likely find themselves on the tail end of the queue. The appalling inadequacy of basic infrastructure will force the state and the foreign donors to funnel scarce capital first to road building, basic telecommunications (for instance, telephone installation), airlines, railways and the like, not to mention the special problems posed by electric power generation -- the handling of those dangerous, badly built nuclear power plants on Europe's doorstep. These sectors, the kind typically operated as regulated monopolies in the US, are very likely to absorb the lion's share of foreign aid and investment.

Electric generation is particularly pressing. The West Europeans want those power stations rebuilt for greater safety, and the European nuclear power industry is hurting terribly from a dismal lack of new orders. This creates a nice opportunity to combine safety in the West with the spread of capitalism to the East and generate business for state supported firms in the West. Electric power generation industries will surely receive massive foreign investments, especially if they are privatized, with which they can purchase equipment and services from the West.

Modernizing infrastructure is expensive. To get an idea of the potential costs, consider German investment into the former East Germany. Germany plans to invest $14 billion in new telecommunications systems and an additional $22 billion in road construction and other transportation networks, in the provinces of the former East Germany.[31] In addition to these expenditures, East European governments are sure to be financially burdened from "meeting the interest and principal payments on the foreign debt, funding the social safety net and retraining programs for the workers becoming unemployed as a result of the restructuring of the economy,

[30] See Johnson, op. cit.
[31] See Treuhand figures, as of December 31, 1991.

financing the pensions and health care needs of the ageing population, modernizing the educational system...., [and] paying for the needed environmental cleanups and safeguards."[32]

The classic infrastructural industries are also the best candidates for privatization. They could produce tradable shares to generate capital markets. They would also be acceptable vehicles for international aid and investment, especially EBRD assistance, tied as they are to a substantial portion of private sector lending.[33] Infrastructural industries are the easiest to manage; they do not have to compete. They can be made to generate correct returns. All in all, they present an ideal set of privatizable activities completely protected from the vicissitudes of markets and competition. Infrastructural industries will remain regulated and thereby generate few of the capitalist virtues that are the whole point of privatization.

Finally, those who expect a major capital injection from the West are likely to be disappointed.[34] For one thing, the recession and the high government deficits run by Western governments have drained the coffers of prospective donors. For another, there are many alternative sources for scarce Western capital in East Asia and Latin America and even eastern Germany and the former Soviet Union.

To this point, the amount of foreign investment flowing into the region has been disappointing. For instance, in 1990 and 1991, Poland received $1.3 billion, Czechoslovakia $.8 billion, and Hungary $2.3 billion.[35] Over the same period, the former East Germany received over DM100 billion in total transfers from western Germany. So far, Western governments haven't been overly forthcoming either. For instance, total World Bank commitments to the region for 1991 only amounted to a little over $3 billion.[36] The EBRD devoted only about $800 million, $377 million for telecommunications loans.[37] Prospects for future foreign investment in the area remain guarded, though the share contributed by international organizations is slated to increase,

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[32] Ellerman et. al., op. cit., p. 287.
[33] According to Rolf B. Westling, EBRD's Senior Country Manager, "...as to our policy of privatization, EBRD conveyed a message to the governments in the region, confirming that it would like to be associated with the process, particularly with the privatization of various utilities, transport companies, power generation plants, telephone companies, and the like." "EBRD: Cooperation instead of Rivalry with World Bank: An Interview with EBRD's Rolf B. Westling." *Transition*, Volume 3, Number 4, April 1992, p. 7.
[34] Jan Vanous is among those who emphasize the importance of a large capital influx into the region. Jan Vanous, "Nuts and Bolts of Economic Reform in Central and Eastern Europe," *Transition*, Volume 2, Number 6, June 1991.
[35] Stephen Engelberg, "Eastern Europe Foils All But the Hardiest of Western Investors," *New York Times*, March 5, 1992, pp. A1 and D8.
[36] Source: *Transition*, Volume 2, Number 6, June 1991, p. 3.
[37] Source: *Transition*, Volume 3, Number 4, April 1992, p. 6.

(4) Business Conditions are Very Risky. Marko Simonetti, director of privatization for Slovenia, argues that the challenge of privatization is to find active owners willing to lead companies through the transition period.[38] But this is easier said than done. After all, why should new owners restructure their enterprises when there may be an immediate payoff if they liquidate the assets? In most cases they shouldn't, especially if foreign competition is allowed. Domestic producers won't be able to effectively compete in world markets, especially against the East Asian NICs. A brief taste of what lies ahead is the case of large state enterprises in eastern Germany; unable to compete abroad, these firms lost their home market when companies from the western part of the country moved in.[39]

The temptation to liquidate rather than to invest is heightened by the asset value of many companies. The company's land, buildings, and the right to do business may be worth more in the marketplace than its productive potential, lying in often dubious and difficult assets like machinery or the labor force. A common story is that of CKD Tatra -- until recently the world's largest maker of tram cars, but today manufacturer of only 300 -- which has attracted investment interest partly because the site of its old factory "occupies acres of prime real estate, a hop, skip, and two subway stops from ... Wenceslaus Square."[40] Prospective investors in this firm would have little incentive to restructure this outmoded tram works when they could easily profit by closing the factory and selling or developing the land.

The state needs to be very careful in establishing market rules and regulations that encourage productive investment and discourage passive holdings.[41] There is a fine line between an entrepreneur who is innovative and one who is rent seeking. Consider the role of incentives in the experience of successful Slovene exporters in the mid-1980s. These firms were the largest earners of hard foreign currency in the area because their products sold well abroad. Ordinarily, one might expect that the exporters would reinvest the profits in expanding its core businesses, perhaps with aggressive marketing or upgrading quality. Yet, at the time, the Yugoslav dinar

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[38] See Marko Simonetti, "Comments on `Accelerating privatization in Eastern Europe: the Case of Poland' by Jeffrey D. Sachs," from World Bank's Annual Conference on Development Economics on April 25 and 26, 1991.
[39] Stark, op. cit., p. 14.
[40] Peter Passell, "Czech Streetcars None Desire," *New York Times*, March 18, 1992, p. C2.
[41] According to Dr. Manfred Balz, General Counsel to the Treuhandanstalt, "The Treuhandanstalt has been quite ingenious in inventing a variety of clauses against disinvestment," including... securing promises from investors to guarantee minimum future investments and minimum employment levels, and incorporating resale clauses in the original sale agreements. Dr. Manfred Balz, "Approval of Privatization Decisions: The Case of Germany," Paper presented at Second CEEPN Annual Conference in Vienna on 30 November 1991, pp. 10-11.

was greatly overvalued. So, like any resourceful Western tourist who happens to be carrying hard currency into a country where the home currency is overvalued, the Slovene exporters exchanged the hard currency earnings with black marketers. In fact, the trading was so successful that the exporters decided to go into the currency trading business themselves, plowing their foreign exchange earnings into trading rather than reinvesting in the productive export business. The result: a classic horizon problem.[42] Hungary has proposed a step to discourage rent seeking by restricting speculation on farmland acquired through reprivatization.[43]

(5) Lack of historical cooperative links between labor, suppliers, manufacturers, consumers. First World countries like Japan and Germany were able to get back on their feet quickly after World War II partly because reconstruction meant the reconstitution of forms of economic organization established years earlier rather than the creation of completely new relationships. For instance, keiretsu, the centralized forms of ownership in Japan, were antedated by zaibatsu which originated in the Meiji era.[44] German business and unions reached durable working arrangements long before the postwar German miracle. The antecedent for the workers councils, a keystone of modern German corporatism, was established during World War I when military imperatives prompted governmental accommodation with labor.[45] Throughout Scandinavia and Western Europe, institutional networks among business, labor, and government which facilitate domestic peace and economic growth evolved over a hundred year period.[46] Manufacturing these relationships in Eastern Europe won't occur overnight.

(6) Poor Work Habits. One element of the Leninist legacy is evidently a work force that doesn't want to work. This report from The New York Times is commonplace: "Managers of new private companies say they must dismiss dozens of people to find one not afflicted by the lackadaisical work ethic fostered by the Communist system. Private hotels in Warsaw do not even accept applications from former state employees."[47] Another element is the hierarchical mentality that still pervades East European

[42] The story was related by Professor Tea Petrin.
[43] See Schwartz and Tyson, op. cit.
[44] Akira Uegaki public remarks at Berkeley, March 11, 1992.
[45] Kathy Thelen, *Continuity and Crisis: Politics Within the West German Dual System of Labor Relations,* 1991. Hans-Joachim Brauer, The German Economy in the Twentieth Century, London and New York: Routledge, 1990, p. 27.
[46] See especially Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe*, Ithaca: Cornell University Press, 1985.
[47] *New York Times*, March 1992, p. A1.

enterprises. In the past, the incentive structures in Communist enterprises discouraged managers from acting with initiative. In most cases, managers, especially middle-level managers, were better off merely to play along with the system rather than risk their position by exercising discretion.[48] This is hardly a prescription for entrepreneurial dynamism.

(7) Ethnic divisions. Many countries in Eastern Europe are fractured by ethnic cleavages, language differences, and religions. In many cases these differences have not been politically or economically resolved.[49] Divisions between Czechs and Slovaks, Croats and Serbs, Hungarians and Romanians, are likely to complicate effective economic policymaking. The situation in Czechoslovakia illustrates the difficulties brought about by ethnic haggling. Populist separatist movements in Slovakia are clashing with reform-minded Czechs like Klaus, with the potential of paralyzing economic reform.[50] Perhaps, an even more poignant example is Yugoslavia, where civil war has relegated economic reform to the back burner.

(8) Small National Markets /Broken International Linkages. The long run economic choices of East European countries will be restricted by the small size of national markets in the region. The countries are mostly both small and poor. To achieve competitive viability, industries in small countries must be active participants in foreign markets. By the same token, it is much cheaper for these exporting firms and domestic consumers to obtain imports on the international market, rather than have these same goods produced inefficiently at home.[51] Ideally, industries in small countries operate in a very open international market, source where value is best and sell internationally in niches. They must be outward looking and very dynamic: exactly the opposite of Eastern European large enterprises.

To approach this norm in the East European case, industrial restructuring will be necessary on a massive scale. But such restructuring means the closings of many, probably most, large enterprises and the loss of thousands and thousands of jobs. Isolated from the world

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[48] Arun Swamy observed that same complaints of bureaucratic behavior in large Western firms.

[49] Ethnic differences need not be fatal for economic compromise. Note, for instance, the impressive economic growth in Belgium where Flemings and Waloons sometimes tangle. There are also important ethnic cleavages in Switzerland and Netherlands, two countries with among the best economic performance records in the world.

[50] Peter Passell, *New York Times*, "An Economic Wedge Divides Czechoslovakia," April 19, 1992, p. 4E.

[51] For a discussion of the challenges of small states see Katzenstein, op. cit.

market, large firms in East European countries produced goods made better and cheaper abroad. They operated in captive markets and they exported on a large scale to similarly noncompetitive foreign markets, within the realm of the planned economies. They learned to operate with constant output and input prices and virtually unlimited access to credit. Sooner or later many of those companies must be eliminated as national resources are channeled into products where the East European countries are likely to have a competitive advantage, not just compared to one another, but compared to the entire world. As one big firm in the region tries to improve itself by sourcing quality components from the world market, it dries up the markets for the other large firms, its traditional suppliers. When local consumers get a little real money and the choice to buy coveted imported goods rather than generally lower quality local product, the entire system collapses.

The industrial structures of Eastern Europe were created with important linkages to the regions of the former Soviet Union. These networks of customers and suppliers are now completely severed. As a result, East European companies have lost the only conceivable buyers for what they produce and the cheap suppliers for what they need in order to produce. The problem is not simply one of efficiency as revealed in price: it is one of political borders, and disruption. Even a substantial increase in efficiency will not make up for the tattered regional industrial structure. It takes years to build a new structure, and a new structure cannot be built until the political uncertainty is overcome. Private investment --obtained in a real capital market -- won't be easily forthcoming in newly privatized companies that are unsure of where their markets lie, where their sources of supply are located, or who their competitors are. And the new international industrial structure of Eastern Europe won't be built quickly. For the future of capitalism in the region it is the most important construction. The hoped-for gains in efficiency will not be realized, and even if somehow they could be realized, they will not compensate for the loss of established inter-industry linkages, economies of scale, economies of certainty.

The situation is something akin to what happened, in that same unhappy region, after the Treaty of Versailles redrew the map of Eastern Europe at the end of World War I. Borders and impenetrable political and economic obstacles separated firms from their traditional customers and suppliers. Activity came to a halt. Thousands and thousands were thrown out of work.

After World War I, it took over ten years for Eastern Europe to return to 1913 levels of industrial production.[52]

These eight obstacles would deter the most ardent reformers from attempting a program of drastic and potentially all-or-nothing industrial change. Not the radical capitalists. In their view, the private ownership of large enterprises will put the East European economies on a solid footing -- in time. According to the radical capitalists, it is precisely because of the problems confronting the region, that it is essential to install private ownership quickly.

The radical capitalist's prescription for Eastern Europe might be tenable given a stable institutional setting -- with a functioning tax code, established financial system, legal system, broad-based capital markets and credible political guarantees, as well as plausibly operating networks of international markets and industrial linkages. But there are few credible tested institutions. Without them rapid privatization won't provide a solid base for prosperity nor will it aid the growth of an active independent entrepreneurial class.

The next section considers the likely consequences of rapid privatization in the absence of just one institution: viable financial broad-based capital markets. We select capital markets because, evidently it is the institution most dear to the radical capitalists, and it plays an important symbolic role in the popular imagination. But any of the others would do just as well; indeed, capital markets are probably easier to create than for example, the honest and extremely competent public regulatory bodies that will be necessary for rapid privatization to succeed, or even for capital markets to function positively.

IV. The Importance of Institutions: The Crucial Role of Capital Markets

Capital markets remove power, in giant dollops, from the hands of entrenched bureaucracies. They are fast, and powerful. They move mountains and provide invisibility for the movers: it is difficult for a public bureaucracy to close down the only industry in a midwestern American town; that now familiar objective is more easily achieved by a twitch on the Tokyo, or New York stock exchange. Capital markets are also a major entertainment industry in their own right, something of a cross between the tables of sporting results that fill so many pages of newsprint and minutes of air time daily, and Hollywood gossip stories that fill

[52] Derek Aldcroft, *From Versailles to Wall Street*, 1919-1929, London, 1987, chapter 5; League of Nations, Industrialization and Foreign Trade, 1945, pp. 134-13

much of the rest of most information media. In these, and many other ways, broad-based capital markets are wonderful creations.

In capitalist economies, broad-based equity markets serve both investors and corporations alike in two general ways. First, equity markets signal the underlying value of securities. Theoretically, this facilitates the proper allocation of resources by providing both investors and companies opportunities to raise cash as well as to spread resources among businesses which vary by product line and investment risk. Accurate share valuations also provide stockholders with a de facto evaluation of management, which may sometimes precipitate corrective action. Second, equity markets provide venues for companies to raise capital (equity or debt) over a wide net of investors. By the same token, equity markets enable investors to more easily control risk in their portfolio. Finally, equity markets ease the costs of investment and corporate restructuring by providing liquidity to both investors and corporations alike.[53]

But price-driven, broad-based, open capital markets are not a *sine que non* for successful "capitalist" type development. As noted above, some of the most successful of the capitalist nations, France and Japan relied on financial systems that did not allocate capital in an open market simply or essentially by price; during almost two generations of rapid post war growth and modernization. Both successfully used centralized systems of priority allocation.[54] Korea is a newer example of spectacular capitalist development with something other than an open, broad-based, price-driven capital market.

Because they are so powerful, capital markets are dangerous, especially when they lack proper safeguards and depth. In Eastern Europe, the hazards are particularly acute because of the complete lack of experience in using these markets. Additionally, capital markets are likely to attract more attention than usual because of their novelty in the region and their significance as a capitalist symbol. To simplify matters the following discussion concentrates on one type of financial capital market: broad-based equity or stock markets.

Radical capitalists assume, correctly in our view that capital markets will arise concurrently with privatization and the issuance of shares. The process is already underway.

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[53] Williamson considers the reverse question, "Can capital operate given state ownership?" His answer is no. "Lacking an effective advocate, capital is predictably misallocated, dissipated, and/or expropriated." See Williamson, op. cit., p. 1.

[54] See Cohen et. al., op. cit.

Today, despite few viable companies, public stock markets are being organized throughout Eastern Europe.[55]

Unfortunately, in spite of the best of intentions, East European equity markets probably won't be able to perform efficiently -- and just may perform with delegitimating perversity.[56] It will be virtually impossible to establish fair market value for the exchange's listed companies given the shortage of capital in the region and the unstable business conditions. The lack of well-established, highly capitalized market participants implies that there will be a lack of liquidity in the equity markets. This will produce equity markets with thin market conditions and wild price swings, since insufficient numbers of large investors will exist to support prices. The inexperience of the domestic traders may also increase the likelihood of intermittent price plunges. Investors are likely to see the values of their portfolios gyrate wildly. Many will lose their investment, and with it faith in the market. Rather than resemble the efficient, "thick" markets of the West like the New York Stock Exchange, East European equity markets are likely to have more in common with the freewheeling stock markets of the Third World.[57]

Corruption is sure to become a big problem. Inexperienced East European market regulators will not be able to police markets that are moving quickly, and without apparent reason. Market rigging and stock manipulation are inevitable. Even in the most sophisticated trading environments, flagrant abuses are commonplace. The charges run the gamut from stock manipulation and inside information to kickbacks and money laundering with organized crime. For instance, in Japan, "...the former top executives of Nomura Securities and Nikko Securities – the largest and third largest brokerage houses in Japan – testified before Parliament that their firms had for years done business with an organized-crime figure, helping finance what may have been a huge stock manipulation scheme." In the US, the popularity of junk bonds and the

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[55] Commodity markets are starting to spring up, in some cases with help from American exchanges. The New York Mercantile Exchange and the Chicago Board of Trade is training Russians and Hungarian traders and regulators.
[56] A neglected issue is what the new shareholders of East Europe will do with their shares. In Great Britain, most recipients of discounted shares from the privatizations resold the shares and spent the found money. Ellerman et. al., observe that the British experience would probably recur in Eastern Europe given the levels of pent-up consumption demand. Ellerman, op. cit., p. 287.
[57] Third World stock markets are characterized by extraordinary booms and busts. In Mexico, in 1986, the Mexican stock market (with only $820 million in share capital spread over the top ten firms) rose over 600% before crashing in 1987. In Turkey (where new share offerings barely exceeded $10 million) over 1986 to 1987 the stock market rose over 1000%, only to drop precipitously later on. Volatile stock markets are also part of economic life in Nigeria, Egypt, Brazil, Thailand, and throughout the Third World. International Finance Corporation, Emerging Stock Markets Factbook, Washington D.C., 1989. Figures are in US dollars, estimated from stock market indices. See also, Henry Brenen and John Waterbury, "The Political Economy of Privatization in Developing Countries," *World Development*, May 1989, p. 620.

dishonesty of unscrupulous salesman like Michael Milken and Charles Keating helped produce the Savings and Loan debacle and the fall of Drexel Burnham Lambert, a large investment house. Even the US treasury auction proved vulnerable to corruption. Salomon Brothers admitted to cornering the market in one of the US Treasury notes in 1991. As the most experienced traders will attest, market operations are very complex and enforcing fair rules can be nearly impossible.

How will inexperienced Eastern European regulators be able to protect investors and enforce the market rules when information is patchy and maldistributed, markets are thin, prices are fluctuating wildly and markets are dominated by only a few players? Answer: They won't be able to.[58] Investors are sure to think they are being cheated, and most often they will be right. This potential for delegitimizing the entire effort to create a functioning market system, even more than any perverse effects the wild new capital markets may have on the optimality of capital allocation, is the primary danger. The first rounds of stock market activity are sure to see managers and their invisible partners in the administration cash in big. A crop of instant millionaires -- whom everyone knew as the old nomenclature -- will become conspicuous symbols to be manipulated by potential demagogues. Eastern Europe may soon have truly "Far West" financial markets, but Eastern Europe is not the Far West; it lacks the vast safety valves and alternative opportunities of that place and time.

If the resentment against black marketers in East Europe is any indication, there will be a ground swell against the "excessive" greed and corruption in the equity markets.[59] Legitimate operators could get caught up in the popular outrage; so might the whole reform movement, especially in the context of large-scale economic misery and uncertainty experienced "by honest, hard working, native people." The reaction is likely to be exacerbated as domestic restructuring gathers steam and many workers lose their jobs. East Europeans may soon give literal meaning to the attitude of Yoshihiko Miyauchi, president of Japan-based Orix Corporation, "Too many

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[58] Another factor that is sure to make regulation much tougher. Business in East European equity markets is likely to be conducted verbally, rather than in writing. East European markets will use a trading method called "open outcry," in which transactions are verbally consummated between buyers and sellers. Only after spoken confirmation between the traders are the trades actually written down and sent to a recordkeeper. Because abuses are most likely to occur around the time of the trades, and since the improprieties usually occur before any trade is actually recorded, corruption is very difficult to prove.

[59] Foreigners, who may play the pivotal role in the home stock markets are likely targets for popular resentment. In 1991, the Budapest Stock Exchange suffered a 25% decline as foreigners--the primary investors--became concerned about growing political uncertainty. *Transition*, Volume 3, Number 2, February 2, 1992, p. 10.

Japanese made money without sweating in the 1980's, which I personally think is unethical....I think we have to kill this sentiment."[60]

Until a viable equity market is operational, companies are likely to go elsewhere to raise capital or sell assets – by privately placing equity or raising capital through debt rather than equity.[61] However, whereas in the West, market valuations can be arrived at relatively quickly due to the relatively free flow of information and the efficiency of markets, in the East, market valuations will be much more problematic. This problem will be exacerbated by the lack of accepted accounting standards and a credible tax system. These added uncertainties will make it much tougher to raise capital. Under these conditions, East European firms will have no choice but to rely on the state, or in special cases private banks or foreigners for their capital requirements. The investment policy of the newly privatized enterprise is likely to become dependent on the state. Independent active ownership may become an illusion, even given a plan of rapid privatization.

V. Public Enterprises Reconsidered

Radical capitalists insist that state ownership and capitalism don't mix, nor do state ownership and rapid development. In their view, the Communist economic malaise is just another failure of state ownership. Throughout the world, they argue, stated owned industries are notoriously inefficient and corrupt. In the Third World, where the state is a major asset holder, the record of state-owned industries is particularly appalling. Little wonder that many poor nations, as diverse as India, Bangladesh, Turkey and Mexico, have embarked on massive privatization programs in recent years.[62]

Yet, state ownership makes sense at certain times, for instance, when markets are imperfect. In Eastern Europe, as in the Third World, there are few private alternatives. Entrepreneurial experience, sufficient capital, developed markets, and modern infrastructure are

[60] James Sterngold, "Japan's Rigged Casino," *The New York Times Magazine*, April 26, 1992, pp. 27-28.
[61] One situation in which companies looking to raise capital may use the equity markets is the case of a rapidly rising speculation-driven capital market. In this circumstance, companies may choose to float stock as share-starved investors pay inflated prices for corporate equity. Such a dynamic is underway in India, where many companies are currently using the stock market as a source for capital. The potential for investor bankruptcies arises, however, if companies are unable to show profits justifying a high stock price and the stock bubble bursts leaving investors holding the bag.
[62] India is more accurately a case of limited privatization. The government is divesting only some portion of company shares while retaining control primarily through state-owned financial institutions and mutual funds.

typically in short supply.[63] Under these conditions, sustained private investment is very difficult to come by, especially from foreigners. Capital shortages are already in evidence in Eastern Europe. East European medium-sized firms are finding it tough to get fresh foreign capital due to the "play-safe attitude of Western banks." This means that industries which may hold long-term economic potential or whose development may be in the national interest will never get off the ground. The state must step into the breach. Finally, and most prominently, there is the repeated history, in country after country where a sudden implosion of whole sectors, sometimes whole sets of sectors, results in the state finding itself forced to step in and nationalize the losers. Hence the typical state sector, with its portfolio of coalmines, steel mills, railways, and shipbuilding docks. Italy and Spain have lavish government portfolios so acquired. This history of nationalizing dying industries in response to political pressures or more simply of managing the difficult task of restructuring and downsizing as painlessly as possible has given state-owned enterprises their bad name. They are, most often, collections of basket cases that no one else would take. This makes their experience particularly relevant to Eastern European big business.

There are, however, examples of state-owned companies, nationalized for one reason or another, that were not already dying. France provides the best examples, and here the history of their performance has been anything but negative. As late as thirty years after World War II, the French state still owned all or major firms in steel; coal; oil distribution, refining, transportation and exploration; automobiles, trucks and busses; rockets, cigarettes, aircraft; electronics; ocean shipping, aircraft, airlines, skyscraper office development, radars, radio and television broadcasting, telephone equipment and services; gas, electricity, plus, horrid as it may seem, most big banks and insurance companies. And this is but a partial list. The post-war modernization, restructuring and growth of the French economy has been, by anyone's standards (except Japan's) extraordinarily successful. What is more, state-owned firms played a leading role, not simply a shock-absorbing role, in that transformation and modernization.[64]

In Japan and Korea the giant industrial groupings that dominate the economy defy simple classification as either private or public. Nor is there any compelling reason to make the

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[63] In rare cases, a surplus of available revenues may actually encourage state intervention. See for example the experience of oil producing Arab states. *Public Enterprises and Development in Arab Countries*, New York, 1978, p. 1 (Cited in V.V. Ramanadham, The Economics of Public Enterprise, London and New York: Routledge, 1991, p. 25.)

[64] On the role of the state and state firms in French industrial modernization, see Stephen S. Cohen, *Modern Capitalist Planning: The French Model*, Harvard University Press, 1969.

distinction. Surely the great Japanese keiretsu are not public firms; the government does not own them. But it is extremely difficult to assimilate the Sumitomo or Mitsubishi groups into the traditional category of a private firm. The market is not the opposite of the government; the firm is not in opposition to the State. There are many varieties of institutional arrangements, and they change with time and circumstance. The all-or-nothing, public bureaucracy or private (capital market based) firm is dangerously simplistic. It pops out of textbook economics, not out of the history of successful economic development, especially "catch-up" development. And that, after all, is the relevant genre for Eastern Europe. The peoples of Eastern Europe do not have to invent their future, just catch up with it.

What determines the success of state-owned enterprises? It isn't just ownership. State-operated industries can be operated efficiently or inefficiently, using technologically advanced production techniques or backward ones. Empirically, the answer is clear. Good performance is a function of the domestic political economy, not just the fact of state ownership.[65] Christianson[66] and Vernon-Wortzel and Wortzel observed[67] that privatization without liberalization produced few gains. In a survey of state enterprises in Asia, Chamnong noted that management rather than ownership was often a better guide to performance.[68] Cohen reached similar conclusions for France.[69] Raymond Vernon in *The Promise of Privatization*, a cross-national collection of case studies of privatization drew the following conclusion:

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[65] The industry type can also be important. Some industries, such as information technologies may actually operate more efficiently as monopolistic public enterprises. Modern production techniques are dissolving traditional boundaries between private and public enterprises. One reason is that the cost of research and development for some technological industries has soared beyond the reach of most large private firms. „Another reason is the nature of production of new information technologies. The lion's share of the costs of manufacturing these products lies in design costs, not actual production costs. Once one computer is produced, average cost declines for each computer thereafter. As a result, competition among firms occurs in the design stage, not in the production stage. This results in the "Balkanization" of knowledge; technological information becomes proprietary Technology is diffused across competitors rather than the development of a unified operating system. A perfect example is machines that don't easily talk to one another, like Apple and IBM personal computers. In Great Britain, privatization of the telecommunications industry precipitated a confusion of different systems and standards in the industry. France, on the basis of planned, state-owned development, took the lead in size and quality of its telecommunications network. By 1983 the size of the French network exceeded that of the British. Furthermore, the French system is the cheapest in Europe. (This argument borrows from Nicholas Costello et. al., "Industrial Restructuring and Public Intervention: Planning the Digital Economy," in Jonathon Michiel (ed.), *The Economics of Restructuring*, England: Edmund Elgar Publishing Limited, 1991.

[66] R.E. Christiansen, "Editor's Introduction," *World Development* May 1989, p.597.

[67] Heidi Vernon-Wortzel and Lawrence H. Wortzel, "Privatization: Not the Only Answer," *World Development*, May, 1989, pp. 633-40.

[68] Vudhichai Chamnong, "Integrated Summary of the Conference," *Management Dynamism in State-Owned Enterprises in Asia,* Tokyo: Asian Productivity Organization, 1989, pp. 1-13.

[69] Cohen, op. cit.

> "...The glaring cases [of differential performance between state-owned and privately-owned industry], however, have revealed much more about the basic character of the government involved than the efficiency potential of state-owned enterprises. Where governments have been reasonably competent and responsible, and where comparisons between private enterprises and state-owned enterprises has not appeared much different than private enterprise. Here, and there a strikingly efficient performance by a state owned enterprise has cast doubt on the simple stereotypes of the public enterprise as a perennial wastrel."[70]

What these examples suggest is that reliance on the public sector and public ownership, in particular, may actually be good strategy. State ownership is certainly not to be sought as an end in itself; nor for the matter, is private ownership of large enterprises. It all depends upon the context in which choices must be made. Where private ownership seems doomed to fail – as in the case of many large enterprises in Eastern Europe – the failure will result in a sudden implosion of the economy and society. In these cases, alternatives to simple privatization should be sought. After all, even mighty Western Europe did not turn over its inefficient traditional industries to the tender mercies of the market. Steel, coal, rails, and telecommunications -- not to mention agriculture -- were nurtured for years in various ways by the state that calculated that the costs of sudden collapse and disruption exceed the costs of inefficiency. State ownership has absolutely no a priori claim as the most efficient choice, but neither does it, by itself, doom industrial growth. Sometimes, such as in unkind times, state ownership may be a good second best alternative; it may help enable enterprises to "buy time" to catch up with more technologically advanced competitors. Moreover, the recent surge of privatization throughout Europe, Japan, and the Third World indicates that state ownership need not be a permanent phenomenon. Those trying to design new systems for Eastern Europe might profitably sift the rich varieties of institutional experience of other countries to see what made for better or worse performance: from state-owned, state-regulated, state controlled, or state in-cahoots-with. For ownership is a complex concept, contingent on embedded institutions. And, given current conditions for big industry in Eastern Europe, state ownership may be more desirable than simple "private ownership." We will argue in the conclusion that the logic of privatization in Eastern Europe does not ensure a dynamic market economy dominated by private firms. It is more likely that rapid privatization will precipitate state reintervention sooner or later.

[70] Vernon, op. cit., p. 4.

VI. Conclusion: The Faulty Institutional Logic of Rapid Privatization

The focus on privatization, and especially on rapid privatization, diverts attention from the implementation of policies and the creation of market firms and institutions that encourage the development of competitive industries and an effective state bureaucracy. More important than the expected benefits of increased efficiency in its big firms resulting from privatization, Eastern Europe needs to rebuild the networks of industrial linkages and trade within the region. It needs outlets for its goods -- especially agriculture to Western Europe. It will need import controls so all savings won't wash out quickly in a wave of consumer buying. And it needs a competent and honest public administration to recreate those international linkages, administer those controls, negotiate those trade agreements, regulate the new and wildly imperfect markets, and buffer the vast shocks of fundamental industrial restructuring.

To the radical capitalists, rapid privatization is a shortcut. Eliminate the state, and voila, economic growth. But this is myth, ideology. The state will not whither away, despite the dreams of the radical capitalists any more than it did in the dreams of Karl Marx. The state will run things for a long time, if not as owner, than as regulator.

Ironically, the logic of rapid privatization does not make the dependence of industry on the state any less likely. The state is destined to be the key player in the economy for the foreseeable future, whether privatization be rapid or gradual. The newly privatized enterprises will depend on the state for financing, but they will also need the state's political goodwill for establishing favorable rules and regulations. Moreover, an interventionist state is mandatory as enterprises struggle with the process of creating firms that can survive under a market system. The state will also maintain a heavy hand in the industrial core of the economy because in Eastern Europe, the inherited industrial structure provides most industries with too few firms for successful self-regulation by competition. And regulation by foreign competition may prove fatal.

Just as substantial state involvement in the economy is inevitable, given rapid privatization, so is protectionism. Newly privatize enterprises unfit for foreign competition are likely to press for protectionist measures, especially since an open domestic economy would be suicidal for local producers. Free competition would open the field for Japan, the NICs, and other low-cost high-quality producers and leave little chance for inefficient domestic producers. They are inefficient now, and by world standards, they will be inefficient and uncompetitive for the foreseeable future. One must recall that neither Japan, nor Korea, nor France nor Germany exposed their "infant industries" to the rigors of foreign competition; nor will Eastern Europe.

Finally, rapid privatization plans aren't necessarily conducive to narrow, active and independent ownership. Some rapid privatization plans envision ownership through mutual funds or through national distribution of share vouchers. In either case, there is no guarantee that active, independent ownership pressing for dynamic restructuring will emerge. Mutual funds owning shares in many firms, as in the Polish plan, may react to poor performance by selling shares, not necessarily by restructuring industry. If they don't, or are not allowed to, they become, de facto, more like Italy's I.R.I. than a Wall Street fund. More importantly, the mutual funds (even with foreign advisors) are likely to advocate conservative measures for change due to the dependence of enterprises on the state, and perhaps ultimately on the workers. Also, it isn't obvious why widely dispersed ownership, as in the Czechoslovak plan, will pressure enterprises to restructure. The new small shareholders are more likely to remain passive, maybe feeling cheated in their investments, as enterprises fail while some insiders get rich.[71] In any event, most big, inefficient enterprises, will remain in state hands -- directly or indirectly -- for the time being.

Grand designs are associated with great risk. So it was with Communism, so it will be with liberal capitalism. But the risks associated with rapid privatization skew the odds toward failure and ultimately toward disenchantment with capitalism and a democratic, more liberal state. Why take the risk? We don’t see a good reason. The big, inefficient enterprises will not succeed as private enterprises. But they cannot simply be abolished. In order to get a functioning market system up and running in Eastern Europe, it will be necessary to keep the state involved in the economy if for no other purpose, than to preserve a space for maneuver and positive action. The structures of capitalism, the institutions of a functioning market system, must be built. That will take time, and breathing room. Radically pure markets won't build them; they will destroy those structures and risk ending the capitalist experiment before it has had a chance to develop into something worthwhile. After all, it was Joseph Schumpeter, the great

[71] Buoyed by investment firms promising a tenfold return in a year, Czechoslovaks have flocked to the voucher plan. The World Bank reports that, "More than half of Czechoslovakia's 15.5 million people have registered to become shareholders;"... "the process involves industrial assets with an asset value of $9 billion." *Transition*, "Milestones of Transition," Volume 3, Number 2, February 1992, p. 11.

advocate of entrepreneurial capitalism, in his brilliant case for maintaining less than perfect markets, who remarked: "You put brakes on a car so that it can go faster, not slower."[72]

The radical capitalist fallacy is that gradualism will ultimately result in the loss of grand vision as local interests forestall change. Their concern is valid, but their prescription is not. Quite the reverse, in fact. Rapidly privatizing inefficient enterprises will increase long-term dependence on the state, while deliberate restructuring will set the stage for firms to embark on their own. Both experience and logic argue that intermediate forms of ownership, sometimes involving the state, may be instrumental in a country's growth. Nonetheless, over the short term there is no choice -- the state will be the key player in the economy. It is the state that will make the crucial economic decisions. Rapid privatization of big, inefficient enterprises is not so much the wrong answer as the wrong question. Too much attention, too much energy and far too much political capital is being devoted to their privatization and not enough to more pressing, but less glamorous issues like enterprise restructuring, the creation of credible legal or tax systems, the rebuilding of a regional network of industrial and market linkages, and the creation of a functioning, reliable state administration. These are the key pieces. Future accounts of economic change in Eastern Europe are likely to characterize big enterprise privatization as myth, or perhaps more accurately, as fad.

[72] Schumpeter, op. cit.