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THE PRINCIPLES OF PRIVATIZATION IN EASTERN EUROPE**

BY

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It is a great privilege for me to deliver a lecture in honor of Jan Tinbergen, and in doing so to express my admiration for him as a scholar and as a person. Along with several generations of economists, I consider myself his disciple. He is an example to us all, not only for his pioneering achievements and the great scholarly value of his life's work, but for the moral purity and uprightness that imbue all his works. I am indebted to him intellectually, but in addition I recall with the deepest gratitude how actively he helped me in the initial stages of my career. It was still rare at that time for someone from the intellectual world of Eastern Europe to appear and try to join the professional currents in the West. Professor Tinbergen smoothed my path in a friendly and tactful way. I was greatly encouraged by the genuine interest with which he approached the problems of Eastern Europe.

1 INTRODUCTION

A wide-ranging debate on privatization in Eastern Europe is taking place, both in the region itself and abroad, among Western experts. The debate, of course, is not confined to men and women of science. Since privatization is among the fundamental issues of the postsocialist transition, governments, parties, international organizations and the business world must take a position on it. A hundred different views have been expressed so far and a hundred different specific programs have been put forward for resolving the problems in practice.[1] I make no attempt here to formulate any hundred-and-first program,

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1 There is a very extensive literature on the subject. I have selected here just a few of the studies in English which deal with Eastern European privatization: Fischer and Gelb (1990), Frydman and Rapaczynski (1990), Lipton and Sachs (1990), Levandowski and Szomburg (1989), and Hinds (1990). An excellent survey of the polemic is provided by Stark (1990). This brief list does not include works concerned with privatization in the capitalist countries.

although I do put forward my own views.[2] My main purpose is to help readers to conduct a methodical analysis of the problem. I outline an intellectual structure allowing people to assemble the body of information they possess and confront the alternative views encountered with each other before formulating a position of their own.

The word 'privatization', which features in the title, is used in two senses. In the narrower sense it means the transfer of assets hitherto owned by the state into private hands. The broader interpretation covers the property relations in the economy *as a whole*, so that privatization of the economy must be understood to mean that the share of the private sector grows until it ultimately becomes the dominant economic sector. This study is concerned with the concept of privatization in that broader sense.

The title mentions Eastern Europe, and in the main the study deals with the group of small countries embarking on the road of postsocialist transition. However, I believe that most of the problems discussed in the study resemble those in the Soviet Union as well.

Section 2 deals with the values fostered during privatization, section 3 with the evolutionary nature of the transformation and the role of the state, and sections 4 and 5 with the main forms of private ownership. Finally, section 6 deals with the pace of privatization.

2 VALUES

Some of those taking part in the international debate put forward their practical proposals on privatization without clearly answering some crucial questions: What purposes do they want the process to serve? What values do they seek to implement? What criteria do they intend to apply to the decision?

I share the philosophy of those who argue that the ends and the means must be clearly distinguished in any analysis of practical tasks.[3] Lucid clarification of the criteria for judgement is also required for any subsequent appraisal of processes after they have taken place. Rather than attempting to detail all the values taken into account, I only mention the ones I consider the most important to the subject. I classify these under four aspects.

1. *The sociological aspect, in longer, historical terms.* What is the new democracy's direction of movement in a society inherited from the socialist system?

2 I first formulated my own proposal in a book (1990). This study further develops and expands the ideas I put forward on privatization, in the light of the subsequent debates and practical experience. My earlier proposals on some questions are corrected in this lecture, where I feel this is necessary.

3 This is one of the methodological ideas that run as a *Leitmotif* through Tinbergen's works. See Tinbergen (1952), for instance.

Socialism in its classical, Stalinist form gave rise to a society which was governed bureaucratically and organized hierarchically. Nationalization extended beyond firms in production to cover practically every activity, so that every able-bodied person, with a few exceptions, became an employee of the state.

In countries like my own – Hungary – where reforms had begun many years ago, there had been a movement away from that ultimate form of *etatism* before democracy arrived in 1989–1990. I shall not deal here with such transitional states, but turn straight away to the longer-term prospects offered by the process.

1-a. It would be desirable for the structure of society to resemble in its main features the structure in the most highly developed capitalist countries. A broad stratum of independent, autonomous business people and entrepreneurs should emerge. Rather than the vast majority of the property being concentrated in the hands of just a small group, there should also be a broad middle class that includes the masses of owners of small and medium-sized enterprises. Society should undergo *embourgeoisement*.[4] The bureaucratic, hierarchical stratification of society should be widely superseded by stratification according to property. In other words, the hyperactive, overgrown role of the state in the economy should be reduced, even though the economic activity of the state will remain considerable.

All this transformation in the structure of society should be coupled with the modernization of production and the other activities of society, through the spread of up-to-date technologies and lifestyles.

This 'Western-style' image of society is seen as an attainable goal by many Eastern Europeans who think about the prospects of transforming society, but it is not, of course, the sole course envisaged, even among those opposed to the concept of society espoused by the earlier socialist system.

1-b. Some people are put off by modern day Western Europe and North America, with their business mentality, commercialism, profit-mongering, and oversized and overcrowded modern cities, the environmental damage caused by industrial civilization, and many other drawbacks. So instead they tend towards an image of another, romantically 'unsullied' society. Those subscribing to this kind of 'third-road' *Weltanschauung* are attracted by the proximity of nature in a village, by the peace of a small town, and by the simplicity of small-scale agricultural and industrial economies.

1-c. There is another 'third-road' image of society where the intention is to blend capitalism with plebeian-*cum*-socialistic ideas. The goal becomes a 'people's capitalism' that would turn all citizens into proprietors.

All these images of future society have direct implications for the way the process of privatization is judged. For my part, I favor an orientation towards the 'Western-style' social structure 1-a, even though I am aware that it has

4 See Szelényi (1988).

many bad features. I am ready to condemn these and advocate efforts to diminish them, but I am also aware that these bad features will inevitably appear. Those who subscribe to 'Western-style' social development must accept it warts and all. I do not consider the 'third-road' images of the future just mentioned either practically attainable or desirable.

2. *The economic aspects.* This does not form a single criterion; a variety of economic interests can be taken into account.

2-a. The most important economic criterion in my view is to arrive at forms of ownership that induce efficient production. One of the most damaging features of bureaucratic state ownership prevailing under the socialist system was that it gave little incentive to efficiency, and in fact frequently encouraged waste. One of privatization's missions must be to bring about a close and overt linkage between the direct financial interest of owners on the one hand and market performance and profit on the other.

Let me pick out three other economic requirements which are also worth taking into consideration.

2-b. The privatization process should help to reinforce the security of private property.

2-c. The fiscal motive: privatization can help to increase state revenue through the proceeds from the sale of state-owned property, in addition, the relief of budgetary expenditure of subsidizing loss-making state-owned firms, and the opportunities of finding new sources of tax revenue.

2-d. The monetary motive: the effects of some forms of privatization are anti-inflationary; they help to eliminate the 'monetary overhang' of unspent purchasing power. Other forms have the precisely opposite effect of increasing inflationary pressure.

3. *The aspect of political power.* Though scholars concerned with criteria of economic rationality or ethics may be averse to considering this aspect, the fact must be faced that privatization of any kind is a political issue. Governing political parties and groups want to reinforce and preserve their power, while those in opposition see the issue through the lens of their aspirations to form a government. So one cannot ignore the problem of how popular, deservedly or undeservedly, any privatization program will be.

3-a. Among the factors considered by those who want to return property confiscated by the state to its earlier owners is the political weight of the group it benefits, or: how many votes can be won at the next election.

3-b. Those who support employee ownership would like to win the political support of this broad stratum in society.

3-c. Finally, advocates of giving free shares or vouchers to all citizens count on the idea being popular with the public as a whole.

I will return to this question later. Let me confine myself here to a single observation. Those who seek political popularity through some scheme or other often forget to examine carefully and critically whether those whose approval they expect really *are* enthusiastic about the idea. I could hardly find a convincing public-opinion survey on the subject. For my part I still have doubts, although I must admit that my skepticism is based on insufficiently reliable impressions. Those who receive the property may be disillusioned and angry, not politically grateful, to find what they receive is less than they expected and were promised, and that the process is slow and cumbersome.

4. *The aspect of distributive ethics.* This system of criteria is another highly complex one, full of inner contradictions. The ethical principles considered here are confined to those connected directly with the distribution of income and wealth.

4-a. Those who suffered losses under the previous system must be wholly or partly *compensated* during privatization. Some take the view that, where possible, the actual items of property confiscated should be returned if they still exist in their original physical form. Others support the idea that the compensation should merely be in money or securities. Several versions of the latter approach are conceivable, with various restrictions on redemption and the degree of transferability.

A range of difficult questions arises in this respect. What kind of injuries deserves redress? Should compensation be confined to the economic damage sustained through confiscation, or should it cover losses of other kinds as well, ranging from cases of unjust imprisonment or execution to those who lost their jobs or were denied the chance to continue their education or to travel abroad? And what should be the earliest qualifying date? Should it be when the communists came to power, or has the time now come to redress the injuries of those who received no compensation under the socialist system for losses sustained in the Second World War and the period of fascist rule, for instance?

Ultimately, those who espouse the ethical arguments for reprivatization want to apply the ethical principle of just recompensing. An economic argument, listed under 2-b, can also be brought forward in support of reprivatization: restoring the old property relations is a tangible demonstration of the idea that private property is sacrosanct. But this argument can be countered with another that likewise rests on criterion 2-b: the protracted process of reprivatization may undermine the security of property relations based on the *status quo*. A building or business claimed by a former owner may already be in private ownership.

Reprivatization can also conflict with other economic criteria. It robs the treasury of income or actually involves extra public expenditure (criterion 2-c). If those entitled to compensation are given securities and these can be traded, many will sell them in order to spend the proceeds straight away on the consumer goods market. That means this procedure will increase the inflationary pressure (criterion 2-d).

A further comment is needed on the programs for compensation through reprivatization. An attempt is made by their supporters to give the impression that the *state* is granting the compensation to a certain section of the public. But what is the state in this context but the sum of all the taxpayers? Compensation by way of reprivatization is a *redistributive* action that transfers wealth to the beneficiaries of the compensation from the pockets of non-beneficiary, tax-paying citizens. There is no question of those who gained at the time from confiscation now recompensing those who suffered losses from it. The members of the *present* generation receiving no compensation have also lost, suffering like everyone else from all the consequences of the economic losses and backwardness caused by the previous system.

4-b. It can be argued on grounds of *moral entitlement* that a specific group has a right to some part of the state or other communal wealth in view of their social position. 'Let the land belong to those who till it.' 'Let factories belong to those who work there.' 'Let state-owned flats belong to those who live in them.' Even if the debate is confined to the ethical plane, it can be objected that the rest of society also contributed to creating these assets. Do today's tillers of good land, today's workers in a profitable factory, or today's tenants of attractive, spacious apartments really deserve more valuable property than those less fortunate? In the last resort, the slogans quoted are redistributive principles that favor some groups in society at the expense of the rest.

4-c. There are demands for *fairness* and *equality*. This principle is voiced chiefly by those who want to divide part of the property of the state among all citizens. The question of whether this program clashes with the other criteria is discussed later on. Let us remain for the time being within the logic of ethical arguments.

The old system failed to fullfil its egalitarian promises: democracy inherits a society marked by unequal distribution of material wealth and intellectual capital. Compared with these initial conditions, little is changed if rich and poor, well educated and unschooled, healthy and sick alike receive a modest free gift. Moreover, the free gift will soon be sold by those in need and bought cheaply by those who are clever and have the capital to buy it. Sincere advocates of a more equal distribution of income and wealth should campaign in the field of fiscal policy, welfare policy and education, health and housing policy, where the scope for furthering their objectives is greater.

Privatization is intended to introduce a capitalist market economy. Although the market and capitalist properties have many useful qualities, above all the stimulation to efficient economic activity, fairness and equality are not among their virtues. They not only reward good work but also good fortune, and they penalize not just bad work but also ill-fortune. While they are useful to society as a whole by encouraging exploitation of good fortune and resistance to ill-fortune, they are not 'just.' I think it is ethically paradoxical to mix slogans of fairness and equality into a program of capitalist privatization.

Mention has been made of a range of criteria whose appraisal can serve as a basis for arriving at a position on the question of privatization. Some of these are compatible and complement one another. But there are also values which conflict with each other in this particular context. Short-term economic interests may clash with the long-term interests behind the transformation of society. Ethical considerations may run up against sociological or economic requirements.

The value judgements on which my own view rests have emerged to some extent in what I have said already, but I will summarize them here briefly. Even though I am an economist, it is aspect 1, the long-term sociological criterion, that I rate as decisive, and I also opt for alternative 1-a, as I consider the emergence of a broad stratum of entrepreneurs and business people and widespread *embourgeoisement* to be of paramount importance. I accordingly place the strongest emphasis of the economic arguments on 2-a: privatization must be accomplished in a way that gives the strongest incentive to efficient production. Although the other economic criteria are also important, I rate them as subordinate to the ones I have mentioned. I acknowledge the fact that aspects of political power also apply, but they do not influence me in my choice of values. I am not indifferent to the moral aspects of distribution, but I would refrain from applying them in the context of privatization.

Naturally I respect the right of others to choose values different from my own. What I would like to recommend to statesmen, legislators, the specialists who suggest legislation and the journalists who monitor and criticize the plans and their execution is this: let them analyze and make public the choice of values that justify the privatization programs they support. Let them face up to the conflicts of values and the 'trade-offs' between conflicting requirements, and admit it openly if they jettison one value in favor of another. Let them refrain from pretending that the practical proposal they prefer is a neutral one that would further all the values for consideration equally well.

3 THE TRANSFORMATION'S EVOLUTIONARY NATURE AND THE ROLE OF THE STATE

A view widely spread is that state institutions should play a very large part in privatization. Such a view can be found in governmental circles. In Hungary, for instance, a central authority called the State Property Agency tried for a long time to concentrate almost every act of privatization in its own hands. A similar kind of centralization could be observed in Germany.

There is also strong emphasis on the role of the state in the views put forward by many foreign experts, who certainly cannot be accused of wanting to increase their own power. I myself have heard the following proposal: the Soviet Union should quickly establish 20 investment funds by state decree. The managers to head them should be appointed by government, with the advice of experts from abroad. The funds should be assigned the shares in the firms formerly owned by the state, and the stock in the investment companies should then be distributed free to all citizens.

I think the inordinate state centralization of Hungary's privatization and the notion of forming investment funds by state decree to manage private property are good illustrations of what Hayek termed a 'constructivist' approach.[5] They are artificially created, whereas the vitality of capitalist development is a result from the fact that its viable institutions arise naturally, without being forced.

During the period of Stalinist collectivization in the Soviet Union, it was possible to eliminate the class of well-to-do farmers, the *kulaks*, by state decree. But no state decree can create a class of well-to-do farmers; that will emerge only by a process of historical development. The state can decide to implement confiscation, but no state resolution can appoint a Ford, a Rockefeller or a DuPont. The selection of the class of owners in a capitalist economy takes place by a process of evolution. And it is an evolutionary process that selects among the institutions and organizations that emerge, causing the ones that are not functioning well under the prevailing circumstances to wither away, and choosing as survivors the one truly fit for their task.[6]

The Polish economist J. Kowalik coined the ironic term 'etatist liberalism' for the curious school of thought that suggests pursuing liberal objectives (private property, individual autonomy, consumer sovereignty) by artificially creating organizations contrived by officialdom, and aims at controlling the transformation of society by bureaucratic state coercion and administrative measures.

What the state should primarily be expected to do is to stand aside from the development of the private sector and ensure that its own agencies remove the bureaucratic obstacles. There are a number of feasible state measures that go beyond this and actively assist in the privatization process, and these are discussed later. But governments should not be expected to replace the spontaneous, decentralized, organic growth process of the private economy by a web of bureaucratic, excessively regulatory measures and a hive of zealous activity by state officials.

4 TYPES OF OWNERS

A. *Personal owners*. First let me give a few examples, to make this concept clear.

1. A family farm or a family undertaking in another branch of the economy, which does not employ outside labor apart from family members more than occasionally.

5 See Hayek (1960) and (1973), chapter 1.

6 The idea that the market performs a natural selection among organizations already appeared in Schumpeter [1911] (1968) and was later elaborated upon in more detail by Alchian (1974). Schumpeter's idea of selection is strongly emphasized in connection with the transformation of the socialist countries in the works of Murrell (1990a, 1990b).

2. A small or medium-sized firm where ownership and management have not been separated and the owner remains in charge.

3. A newly founded firm in Schumpeter's sense, managed by the entrepreneur establishing it and normally employing borrowed capital, not the entrepreneur's own.[7]

4. A joint-stock company of any size in which an individual or group of individuals has a dominant share-holding. This need not necessarily be a majority of the shares; a holding of 20-30% is often sufficient to give the dominant owner (or group of owners) a decisive say in the choice and supervision of management and in major financial matters and investment decisions.[8] Dominance of this kind can emerge so long as the other shareholders are sufficiently passive, which can be the case, for instance, if ownership of the shares is fragmented. The situation may be similar if the rest of the shares are held by the state, and the state refrains voluntarily from active intervention in the firm's affairs.

5. A firm in which the former chief executive officer or a group of managers have become owner's, or at least dominant shareholders, through a management buy-out.

I have not conducted a rigorous classification of mutually exclusive cases, merely listed examples, and these may overlap in some feature or other. The examples can cover small, medium-sized and large firms alike. They may take legal forms that entail unlimited liability or liability limited to various degrees, and range from a family farm to modern joint-stock companies. So what, in the end, do these cases have in common? The presence of a live, 'visible,' 'tangible' person or group of persons at the head of the firm. This individual, family or group has a strong and direct proprietorial interest, so that the size of the firm's profits or losses affects the owner's pocket. In addition, the owner either runs the firm directly or plays a dominant role in hiring and firing the managers and overseeing what they do.

A *personal owner* can enter the stage of the postsocialist economy in two ways. One is by setting up a brand new undertaking. The other is by buying part or all of an existing state-owned firm. The two methods are often combined: a state asset is bought by an existing private firm.

I believe this personal owner to be the key figure in Eastern European

7 'The original nucleus of means has been but rarely acquired by the entrepreneur's own saving activity...' writes Schumpeter [1949] (1989, p. 266), and goes on to catalogue the various sources of finance, including the credit system. One of the sources 'was tapping the savings of other people and 'created credit'... 'Credit creation' introduces banks and quasi-banking activities...' In this study and several others, Schumpeter analyses the connection between the credit system and entrepreneurs in detail.

8 The term *noyau stable* (stable core) has become widespread, following French literature. See Friedmann (1989).

privatization. Let me recall the previous section of this study, which I ended by outlining my own selection of values. It is compatible with this selection to assert that the appearance of personal owners on a mass scale will ensure to the greatest extent the desired transformation of society, the *embourgeoisement* (criterion 1-a), and the incentive towards efficiency (criterion 2-a). Moreover, if one constituent of this process is the purchase of state assets, it will also satisfy the fiscal and monetary criteria (2-c and 2-d). It can be stated, therefore, that the vaster the area in which ownership and control pass into the hands of personal owners, the more successfully privatization will proceed. One of the most encouraging features of the transformation in Eastern Europe is the perceptible advance of this evolution.[9]

There is a widespread notion that an upper limit on privatization by purchase is set by the amount of savings accumulated by the general public. Comparisons of the savings at the public's disposal with the value of the state's wealth are used to arrive at alarming forecasts. The conclusion reached is that it could be 50 or a 100 years before the public has managed to buy up the state's wealth. So there is no other solution: the property of the state can only be reduced quickly by distributing state assets free of charge.

In my view this line of argument relies on false premises. The purchasing power intended by the public for investment (including the purchase of state property) can be multiplied several times by suitable credit and deferred-payment schemes.[10] The proportion of the down-payment to the credit or deferred payments can be as little as 1:10 or 1:20. This proportion is what determines right from the start how much of the state's wealth can be bought by those wanting to go into business with the savings they initially possess. In addition, the process can speed up as soon as some of the businesses start to show a profit and a greater propensity to invest. Above all, it depends on the domestic and foreign banks and other financial intermediaries what range of attractive credit and deferred-payment schemes they offer. Moreover, the main way foreign governments and international financial and economic organizations ready to help can contribute to building up the private sector in Eastern

9 Statistics in the Eastern European countries have reached a critical situation. All previous statistics were based on detailed information provided by the large state-owned firms. Their proportion is shrinking. At the same time, the statistical offices are not equipped, neither organizationally nor methodologically, to observe and measure the activity of the private sector, least of all under circumstances in which the private sector tries to disguise as much of its activities as possible in order to escape taxation. So it is impossible to give reliable estimates for the scales of expansion of various types of private ownership as a whole.

10 Here again I draw attention to Schumpeter's statement on the relation between the entrepreneur and the credit system, quoted in note 7. Schumpeter attributed such importance to this that he incorporated it into the *definition* of capitalism he formulated: 'Capitalism is that form of private property economy in which innovations are carried out by means of borrowed money.' (Schumpeter (1939), Vol. I, p. 223.)

Europe is by setting up financing and backing schemes of this kind. To some extent special 'venture-capital' institutions will have to be established, for there is no denying that special risks are attached to lending money to new private businesses in a postsocialist economy. But these risks can be reduced by an appropriate mortgage system to ensure that the property reverts to the lender if there is a default on the payments. Alternatively, the lender can be a co-owner from the outset. And if the state really wants to be active, it should go about it by offering at least partial credit guarantees that lessen the lender's risk. The majority of private entrepreneurs will, in any case, be more reliable borrowers than many inviable state-owned firms which repeatedly bailed out even though they defaulted on their loans.

As long as the credit and deferred-payment schemes are devised with sufficient caution, they will not entail a risk of inflation. In fact, the debt repayments and interest will siphon some of the potential consumer spending away from the entrepreneurs (criterion 2-d).

It is worth drawing particular attention to the question of management buy-outs. The public is ambivalent towards them. It is pleased that experts, rather than dilettantes, take over the factory, but displeased to see members of the '*nomenclatura*' under the old regime transmuted into born-again capitalists. In my view it is not worth legally prohibiting something that will inevitably occur. It is more expedient to bring the occurrence into the open and place it under the supervision of the public, the law and the appropriate authorities. Clarification of the moral and business rules for management buy-outs is needed, including the normal credit terms. Let a manager or group of managers capable of buying a business property from the state according to these rules do so by legal means.

Special attention should be paid to the question of peasants wanting to farm privately, private small-scale industry and trading, and small business as a whole. It is quite common in the developed market economies for these groups to receive credit on favorable terms, and possibly longer or shorter-term tax reductions. This is appropriate in Eastern Europe as well, particularly now, when the aim is to set these groups on their feet and encourage new small businesses on a mass scale. One factor in criterion 1-a is the creation of a broad middle class; an important ingredient in that process is the speeding up of the development of small and medium-sized firms.

This ties in with another range of problems: how to overcome the distortion in the size distribution of firms. Excessive concentration took place in the socialist economy. Whereas the larger proportion of employment in most Western and Southern European countries is in firms with less than 500 employees, small and medium-sized firms in most Eastern European countries were wound up on a mass scale or artificially merged.[11] The need for a

11 Ehrlich (1985), using data for 1970, made a comparison between the size distributions of industrial firms in a group of Western European capitalist and Eastern European socialist countries. According to her calculation, only 32% of those employed in capitalist industry worked in firms with more than 500 employees, while 66% of those in socialist industry did.

healthier size distribution is among the reasons for giving favorable consideration to credit applications from small and medium-sized businesses.

B. *Employee ownership.* I am thinking here of the form in which the shares in a state-owned firm which has been converted into a joint-stock company are taken up by its employees. The most commonly used term for this in Anglo-Saxon writings is employee stock-ownership plan (ESOP). The idea comes in a number of variants; in some the employees receive all the shares, and in others only a smaller proportion. The proposals also vary on the conditions under which the employees receive the shares, ranging from entirely free distribution to price and payment conditions that are more favorable than the market terms. Finally, various suggestions have been put forward on what limits to place on the sale of the shares, for instance restricting transferability either temporarily or permanently.

The decision makers are influenced primarily by the political criteria when they consider this form of ownership. So long as the politicians have convinced themselves through reliable research into public opinion that there is a real call for employee stock ownership, and that employees actually demand it, I see no particular danger in accepting some moderate version of it, *i.e.* in offering the employees, on favorable terms, a fairly small proportion, say 10-20% of the shares in a firm due to be privatized. In my view it is more expedient to offer the shares for sale to the employees at a large discount than to give them away for nothing.

In the case of a smaller firm, it is also conceivable for all the shares to pass into the hands of the employees, in other words for the form of ownership of the firm in question to come close to a partnership or a true cooperative.

The consistent (or perhaps I should say extreme) advocates of employee ownership go much further. They would like all state-owned firms (or as many as possible) to assume this form of ownership entirely, irrespective of their size. Many of them couple this proposal with the idea of transfer free of charge. They put forward two main arguments for their position. One is criterion 2-a: an employee who is also an owner will have a stronger incentive to produce efficiently. For my part I do not see proof of this. On the contrary, if employees choose their own managers, the managers become dependent on their own subordinates, which can undermine wage and labor discipline. Sufficient evidence for this assumption is provided by the experience with workers' self-management in Eastern Europe, particularly Yugoslavia.

The other argument advanced for comprehensive employee ownership is to choose criterion 4-b from the aspect of distributive ethics: let the factory belong to those who work in it. My counterarguments have been expressed in the section on value criteria.

I would expect the various forms of employee ownership to gain a similar position to the one they have in the developed Western European and North American countries sooner or later, in other words that they will represent a respectable proportion, but they will fall far short of becoming the dominant form.

C. *Institutional ownership.* This large group of property ownership needs dividing into sub-groups before I can comment properly on the alternative ideas put forward.

C-1. Banks and other banking institutions. Some of the postsocialist economies inherited from the socialist economy a two-tier banking system in which there were already commercial banks alongside the central bank. Certain postsocialist countries, which entered the postsocialist period directly, skipping the period of reform within socialism, still inherited the monobank system, and are now obliged to set up a network of commercial banks. But whichever of the starting positions pertains, the banking sector has the following characteristics at the beginning of postsocialist transition.

The sole owner of the banks is the state. There may have developed what is known as 'cross-ownership', under which state-owned firms outside the banking sector are shareholders in the banks, sharing ownership with the institutions nominated for the task by the state administration, and contrary, a bank may hold shares in a state-owned firm which has been converted into a joint-stock company.[12] But cross-ownership remains merely an indirect form of state ownership, and is no substitute for privatization.

The various organizations making up the banking sector of Eastern Europe are engaged in a quite narrow range of activities. Developed market economies possess a great many financial institutions that do not qualify as 'banks' according to the strict legal and economic criteria in force, such as credit-card companies, venture-capital companies, investment funds, mutual funds, saving-and-loan associations, exchange bureaus and so on. There are strong reasons why postsocialist economies need to develop a banking sector with a similarly varied and multiple profile.

Some of these bank-like financial intermediaries (which cannot be called 'banks' in the strict sense) may appear in private-ownership form from the outset. A major role in the development of the new quasi-banking institutions can be played by foreign capital.

The development of genuine private banks, particularly large private banks, seems more difficult, even though their activity is clearly essential to a modern market economy. On the one hand, foreign banks can be expected to open branches in the Eastern European countries, and of course these will be real private banks. It is possible that one or two institutions performing quasi-banking functions that were privately-owned from the start may be converted into true banks. Smaller banks performing local functions could be formed by domestic entrepreneurs. Alongside all these developments, the privatization of the currently state-owned commercial banks will take place. Particularly in the

12 Cross-ownership was discussed in my book (1990). Detailed descriptions of the phenomenon, based on experiences in Hungary, can be found in the studies of Móra (1990) and Voszka (1991); these had not yet reached me at the time this lecture was delivered.

beginning, this will presumably mean only partial private ownership and mainly foreign involvement.

Privatization of the banking sector in the broad sense will not take place all at once. It will take some time before private property becomes the dominant ownership form. Several factors will play a part in this.

One bottleneck is shortage of expertise, experience and up-to-date technical equipment. One only has to remember that these are countries where even payment by check has yet to spread among the population and in trade and services. Another example of backwardness is that consumer credit is used only sporadically in these economies.

Another requirement for development is the creation of requisite legislation, and, beside that, success in building up a system of state regulation and supervision of the banking sector. It would be desirable if state intervention were not on a scale as to stifle individual initiative, but at the same time the sector cannot be left to its own devices. The security of depositors and the financial stability of the country both require legal, insurance and supervisory guarantees.

The subject so far has been privatization of the banking sector itself. However, this ties in closely with the privatization of other parts of the economy. Reference is often made by debaters on the subject to the German (erstwhile West German) and Japanese examples, where a sizeable proportion of industrial shares is in the hands of large banks. On these grounds the recommendation is presented that a considerable proportion of the shares in the state-owned firms should already have been handed over to the Eastern European banks.

Not much will be achieved, in my view, if this idea is applied prematurely and hastily; it will be ineffective chiefly in terms of criteria 1-a and 2-a, which I consider the most important. It will not produce a true owner with a strong interest in increasing efficiency. There are many cases at present where a large state-owned firm making heavy losses is closely tied up with a large state-owned bank, which may be a shareholder and is usually its main creditor. If that is the case, the bank and the firm share an interest in seeing the firm bailed out and artificially sustained. The danger is that if a bank, under the present property relations, is also a shareholder in large joint-stock companies, it will fail to apply business criteria adequately.

Another danger is that the state-owned banks will remain the 'politicized' institutions they were before. The parties in government will, at any time, treat them as their own backyard, and try to plant their own people in leading positions. This is also a warning against the plan to turn the banks in their present state into factory owners, through a deed of gift by the state, even though the banks themselves are owned by the state.

My view is that it will become desirable at a later stage for the ownership relations to develop along the lines just mentioned in connection with the Japanese and German examples. As the weight of domestic and foreign private ownership increases among the owners of a bank or a quasi-banking institution,[13] they can become partial owners of formerly state-owned non-financial firms. The more a bank or other bank-like financial institution operates on a truly commercial basis and is dominated by private ownership, the more it can be expected to satisfy criterion 2-a: to exercise strict control over the firm it owns and take a truly proprietorial attitude. In other words, as privatization of the banking sector advances as an organic process, so, at the same rate, can whole blocks of shares and portfolios of holdings in various firms previously owned by the state pass into the ownership of the banks. For instance, such blocks and portfolios could form part of the state's capital contribution to joint ventures established in the banking sector.

C-2. Pension funds. The pension funds have become one of the main holders of corporate shares in several developed capitalist countries. Notable in this respect is Britain, where more than half the shares are in the hands of the pension system.[14] Many participants in the privatization debate recommend that the pension funds in Eastern Europe assume a similar ownership role. So the problem must be discussed in a little more detail.

The provision of pensions was a task of the state under the socialist system. Pension contributions were paid as tax and pensions were a liability on the state budget. Even where pension provision was in the hands of a separate institution and the sum received in pension contributions was nominally treated as a separate fund, any surplus in the fund was utilized in practice by the state and the state covered any deficit. Although the real value of pensions was always quite low, and further reduced by the effects of inflation, the nominal sum was guaranteed by law. No other decentralized pension system operated in the socialist economy.

Radical alteration of the pension system came on the agenda during the post-socialist transition, but the final forms it will take have yet to be developed in many Eastern European countries. The pension systems of the developed capitalist countries are not uniform in any case, and no consensus has emerged in Eastern Europe on which Western country's pattern to follow. Although it is not a task for this study to take a position on this, the role of pension funds cannot be avoided in connection with institutional shareholdings. I therefore start out from the following assumptions.

Sooner or later a mixed system emerges. One of its segments is a state scheme

13 Let me repeat something underlined earlier: the key issue is not the percentage of the shares in some private owner's hands, but whether or not the private owner has a decisive say. It is possible that a reputed foreign bank might become the dominant owner of a Hungarian bank even though it is only a minority shareholder.

14 According to Schaffer (1990), 32% of British shares were in the hands of pension funds in 1987 and 25% in the hands of insurance companies. As for the role of pension funds and insurance companies, Schaffer's proposals resemble in many respects the idea put forward in this study.

with the task of guaranteeing a pension on at least a subsistence level for those qualifying for it. Of course a guaranteed state pension above this minimum level can be laid down by law, but this must only be done in the knowledge that the ultimate financial source is taxation, or social security contributions collected in the same way as taxation.

The other segment of the pension system is private in nature, and its primary source of funding is the payment of voluntary contributions. Their cost is shared between employers and employees according to legal stipulations and labor contracts. The network of pension funds is decentralized, and it can be joined by both non-profit organizations, whose sole task is to provide their members with pensions, and profit-oriented insurance companies, which undertake to pay annuities similar to pensions.

The revenue and expenditure of the state segment rest on compulsory legal stipulations. Membership of the private segment, on the other hand, is voluntary. Employers and employees are free to decide whether to join or not. In the case of a developed decentralized pension system, every employer or employee can choose between several kinds of private pension schemes.

There is no way of telling beforehand exactly what the future pension system in Eastern Europe will be like, but it seems quite realistic to assume that it will resemble the system just outlined. It is also clear that the transition to a mixed system (containing a private segment) can only be gradual, for the starting point differs among generations. Those already on pension or approaching pensionable age no longer have a choice; they must be provided with a guaranteed pension. The longer the life expectancy for individuals, the more possible it becomes, in this respect as well, to offer them freedom of choice. They may decide at their own risk whether or not to devote part of their savings to some private pension scheme or other. It will clearly be a long time before a mature, responsible, decentralized private pension-fund sector develops. This also belongs to the type of process I termed organic development.

Let us now return to the question of shares. Numerous private pension funds in the West invest the capital accumulated from contributions in shares and other securities.[15] The funds employ professional managers who try to build up the most favorable portfolios, paying close attention to the interests of their members. Although they are able to control all purchases and sales of this enormous fortune, they can only assert their influence indirectly, by buying certain securities and selling others. Their transactions influence market prices, which are then reflected in the valuation of the companies. This ultimately has a disciplinary effect on company managers, as a sharp drop in the valuation of their company sheds a bad light on them, while a conspicuous rise in valuation is evidence, of varying accuracy, of their success. In all events, this kind of

15 Many pension funds in the United States, for instance, leave it to the contributors to decide what proportions of their contributions are to be invested on the stock market, the bond market and the money market.

ownership only partially satisfies criterion 2-a: to provide an inducement to company managers and effective control over them.

Starting out from the value premises put forward in the first section, the conclusions in relation to privatization are obvious: it is worth aiming to turn the decentralized pension funds into shareholders. There is no need to rely exclusively on them investing part of their accumulated contributions in shares at some future date. The establishment of non-profit, private pension funds could be helped in the first place if each were assigned a portfolio of previously state-owned shares as a constituent of their initial capital. The transfer can even be free of charge, for there is an implicit offset: they are taking over some of the pension commitments which have hitherto been borne exclusively by the state budget.

Legislation is needed, of course, to lay down the conditions for such transfers. Care must also be taken to provide them with portfolios of shares which can be expected to have a positive yield. Otherwise the transaction will be fraudulent, for the ones who suffer will be the pensioners whose pension expectations include the prospective yield from the fund's shareholdings.

Moreover, the difference between pensions from the state and pensions from the private segment must be made clear to the voluntary members of the decentralized pension systems. There is a degree of exposure in either case. Pensioners in the state segment are at the mercy of those who devise and apply the legislation on pensions provisions, while pensioners in the private segment are exposed to the fluctuations of the security market and to the degree of success with which the private pension fund manages its securities.

The value premises also show what plans should be rejected. The idea has come up that the state pension system should receive shares before any decentralization and privatization of the pension system takes place. In Hungary, for instance, the transfer has actually begun. This, in my opinion, is a pretence move, from which no particular benefit can be expected. The centralized, state pension system is a branch of the state bureaucracy, and so it should be. But if its function is to provide pensions guaranteed by law, its sources of income should not be exposed to the fluctuations of the stock market or the fortunate or unfortunate trends in corporate profits.

C-3. Insurance companies. Here the situation is very similar to the case of the pension system, and so the conclusions can be drawn straight away by referring to the previous point.

So long as the insurance companies are large, oligopolistic institutions exclusively owned by the state, it is only a pretence measure to transfer shares to them. The result is just another form of 'cross-ownership' discussed earlier, since one state-owned institution becomes an owner of another.

The value premises I have made suggest that it is worth supporting a partial privatization of the insurance system. The system might contain state and private segments operating side by side, and the latter include both non-profit and profit-oriented insurers. The private insurance companies should be encouraged to invest some of their accumulated capital in shares. With suitable legal guarantees and supervision, the state could hand share portfolios over to non-profit private insurers, even free of charge, as a way of encouraging their establishment and consolidation. This again is a kind of ownership transfer where there is an implicit offset: the private insurance sector which emerges by a process of organic development can steadily take over some of the commitments of the guaranteed state insurance system.[16]

C-4. Cultural and educational institutions, charitable societies and foundations, churches. The list contains the kind of institutions which in a developed market economy may invest some of their accumulated savings in shares or other securities. The same will no doubt apply in Eastern Europe. The tighter the bonds tying the leaders of such an institution to the institution itself, the stronger its traditions, and the greater the responsibility they feel for the performance of its functions and for its financial position, the more they can be relied upon to be good custodians of the wealth placed in their charge. For that to happen, of course, such institutions must find financial managers who can perform the task of handling their securities professionally.

Here again one has a group of potential buyers of state property: these institutions can be expected to purchase shares. But the process can be speeded up as well. My value premises do not advance any argument against such institutions receiving share portfolios even free of charge. The only requirements are suitable legislative and supervisory guarantees. And one must ascertain, of course, that there are the vital social conditions to ensure that the institution receiving the gift of state property will really be a good custodian, because those running it have the institution's interests at heart.

C-5. Local governments. Some of the wealth of the state previously managed centrally is likely to be transferred into the hands of local government authorities. This is a necessary and desirable trend, since it promotes the decentralization of power, but it clearly does not mean privatization. A municipality is part of the state, and so once again, the property is passing from one arm of the state to another. It is worth mentioning this because the cases covered by C-1 to C-4, which can really imply privatization are frequently confused in

16 Let me draw special attention to the need for this transfer of commitments to be conducted fairly. Under no circumstances should the individual citizen (in case C-2 the pensioner and in case C-3 the sick or other insured person) suffer losses. Nor should it happen that the state segment hastens to shed its commitments, arguing that the private segment has now received free shares, if in fact such shares do not yet ensure enough income to cover the outgoing pensions and insurance claims. In this respect particular attention, foresight and caution are required to guard private citizens, already troubled by uncertainties, from further worry.

debate with case C-5, which is merely decentralization within the state, not privatization at all.[17]

Having come to the end of the discussion of institutional forms of ownership, there are some further general observations to be made. It is inadvisable to create the institutional forms of truly private ownership in a bureaucratic way, by state decree, all at once. And apart from being inexpedient, it is not usually possible in any case. Such institutions will arise through processes of evolution. The speed with which they develop depends on several factors, for instance the inclination of domestic and foreign capital to invest in them (C-1, C-3), and the availability of domestic and foreign professional staff capable of managing institutional share portfolios (C-1, C-2, C-3, and C-4). But it also depends on the activities of the state's legislators and executive apparatus: on how fast the right legal frameworks and supervisory institutions develop, how much initiative the bureaucracy shows in bringing the requisite new institutions into being, and finally to what extent there is a free transfer of state property to create the initial capital for the organizations serving as institutional owners.

D. *Anonymous shareholders.* An important part in modern, mature capitalism is played by anonymous shareholders who do not themselves possess enough capital to make them heard directly at the general meeting of a joint-stock company, but are able to vote with their feet. If they do not have enough confidence in the future profitability of a firm in comparison with the profitability of alternate investments, they sell their shares, or in the opposite case, they buy shares. The trend in the demand, supply and price of the shares then exerts indirect influence on both the major shareholders represented at the general meeting and the management of the company. This indirect influence is applied through a broad network of intermediaries: the stock exchange, the brokers, and the banks or other financial institutions dealing with the purchase and sale of shares.

These institutions of ownership are beginning to appear in the Eastern European economies as well. Stock exchanges already function in the capitals of a few countries and they issue reports on the turnover and daily prices of the publicly traded shares. But all this is still in its infancy. It will take time before this form of ownership, along with the primary and secondary markets for securities, becomes widespread by a process of organic development. A great many things are needed for this to happen: expertise and routine, confidence, a large corpus of competent staff, the right legal regulations, effective state supervision, and so on.

17 It is another matter that the transfer of some of the state wealth previously handled centrally to the ownership of local authorities may speed up the privatization. This effect only ensues, of course, if the local authority is legally authorized to place property in its possession in private hands, and if it has an economic incentive to do so as well. Also important may be whether the elected local authority officers and councillors think their assistance to privatization will be popular with their voters.

Let us take a look into the more distant future. One can expect the role of joint-stock companies and the distribution of their ownership to develop in a similar direction to the one in the developed capitalist countries. So what are the characteristics of the situation there?

In a range of European countries where the capitalist market economy has operated continuously, without the interruption of the socialist system, only part of the total productive wealth operates in the corporate sector, composed of joint-stock companies, and only a proportion of the corporate sector is accounted for by companies whose shares are publicly traded.[18] This proportion is smaller in continental Europe than in the U.S.A. or the U.K.

Some people are prepared to invest their savings in shares voluntarily. But others will not take the associated risk and prefer other kinds of investment. That is one explanation for the concentration in the distribution of share ownership. In the United States, for instance, the Securities and Exchange Commission has demonstrated that 87% of the population on the lower level of income distribution owns only 1% of the shares, while those in higher income brackets own 99%. Within this group, the richest 1% own 80% of the shares, and the very richest 0.1% own 40% of the shares.[19]

So real capitalism is not 'people's capitalism.' In the light of the American figures, it seems a curious idea to turn all citizens into shareholders overnight by a free distribution of shares. To use Hayek's terminology again, this is a 'constructivist' idea, artificial, contrived, and therefore quite alien to the real development of capitalism. I do not think the whole population treasures an inward desire to own a little piece of share capital. Moreover, there is a danger that the expert, honest and adequately supervised institutions and staff required for a primary and a secondary market in shares of such a giant extent will be absent.

For my part I expect only one benefit to come from mass share-distribution campaigns, and that is a drastic reduction in the proportion of state ownership. That may facilitate the expansion of a dominant group inside a joint-stock company, because it will no longer be confronted with a predominant state owner. This advantage in itself should not be underestimated, but one cannot expect too much of it either. Ownership of share or voucher allocations for every citizen will do little to further the two purposes to which I gave particular emphasis in the section on value criteria: development of broad strata of entrepreneurs and business people (objective 1-a), and strengthening of the incentive towards efficiency (objective 2-a). At the same time, I fear there will be negative effects for the other economic criteria. The state treasury, hard-pressed in any case, loses the potential income from sales (criterion 2-c). Some

18 This should be understood to mean the shares which are quoted and traded on the stock exchange.

19 The figures are from Light and White (1979), p. 338.

recipients of the gift soon pass on their shares or vouchers and appear on the consumer market with the proceeds, which raises the inflationary pressure (criterion 2-d). In all events, this is a trade-off in which the advantages of speeding up privatization are opposed by drawbacks which merit serious consideration.

It seems there will not be a general, free distribution of shares or vouchers in East Germany or Hungary, but implementation of such ideas are quite far advanced in Poland and Czechoslovakia. Experience may refute the skepticism expressed above, in which case I am prepared to review my position.

As mentioned before, the justifications given for schemes which distribute shares or vouchers to all citizens free of charge include arguments based on distributive ethics as well: this is considered to be a start for the new capitalism that is fair and offers equal opportunities (objective 4-c). I have put forward some of my counter-arguments already. I would now like to add a further observation after the survey of institutional forms of ownership. Those who really want to improve the equality of opportunity and approve of distributing state property free of charge should press for the donation of truly profit-yielding shares to charities, health and educational institutes, foundations offering scholarships and other similar, non-state, autonomous institutions. This would really help to improve the position of those way down on the distribution scale of income and wealth, and would do so more effectively than a handout of shares or vouchers to rich and poor alike.

At this point it is worth summing up briefly my point of view on free distribution, which has been touched upon at several points in this study. There is, in my opinion, a case for a gratuitous transfer of part of the wealth formerly owned by the state to new private owners. The following can be included among them: private, non-profit pension and insurance institutions, cultural and educational institutions, charitable societies, foundations, and churches. In effect, the discount price of shares purchased by employees also contains a gift element. These transfers should only be made under specified conditions. (The conditions have been mentioned in this study.) I do not see a justification for any distribution of gifts beyond that.[20]

5 DOMESTIC AND FOREIGN OWNERSHIP

The question arises with all forms of ownership and institutions discussed so far as to whether the owner is domestic or foreign. Let me first put forward two extreme points of view. One is a position of narrowminded nationalism and xenophobia, whose exponents want to exclude all foreign imports of capital,

20 In my book (1990), I rejected the idea of granting all citizens free shares or other securities, and did not touch on other forms of free transfer at all. So my present position corrects my earlier one on an important point, because I now support a few forms of free transfer indicated to be both feasible and desirable.

seeing in them a threat to national independence and the specific national character of the emerging economy.

This position, in my view, causes serious damage. Eastern Europe has a huge need for foreign support in all forms. It is particularly important to have direct foreign investment of capital in all sectors of the economy, but most of all in the financial sector. It is desirable that foreign capital should take part in the purchase of the firms formerly owned by the state. Where the property is bought by a serious foreign firm, it enters as a real owner, fulfilling the requirements of criterion 2-a, that there should be an incentive towards efficiency and strict control over management.

I also do not agree with the other extreme: the position that the proportion of foreign capital in any sector is quite immaterial. The economy contains key positions which are expedient to keep in national hands, because they are indispensable to sovereignty. It is worth ensuring, through a circumspect policy, that the source of all capital investments from abroad should not be concentrated in a single country, but spread among various countries. This gives the recipient country more scope for manoeuvre and so reinforces its independence. Apart from those considerations, there is a need for the country's own citizens to take part in the forming of a large business class, as that will strengthen the domestic base for a market economy founded on private property. Among the requirements of criterion 1-a, the transformation of society in the direction of *embourgeoisement*, is that capitalism should strike root primarily in domestic soil.

6 THE PACE OF PRIVATIZATION

Those who take part in the debates on privatization are frequently asked whether they recommend fast or slow privatization. I think the question is phrased in the wrong way. No one would call himself an advocate of slowness. If I may add a subjective comment here, I myself am particularly put out if people call me an advocate of slow privatization.

What the debate should be about is not the speed but the choice of values, the role assigned to the state, and the assessment of the importance of the various forms of ownership and types of owner. Once anyone takes a position on these points at issue, the speed to be expected arises *as a result* of that decision.

I would like to declare that I am a believer in the process of privatization proceeding as fast as possible. But I do not think that it can be accelerated by some artful trick. I do not believe that finding some clever organizational form plus bureaucratic aggressiveness in enforcement are sufficient conditions for fast privatization.

The key issue, in my view, is not the pace at which the wealth hitherto owned by the state is transferred into private hands. The most important thing is the pace at which the private sector grows, (i) in the form of newly established firms, or (ii) through the transfer of state wealth, or by combinations of both these forms.

The following calculation is easy to check. Let us assume that at the start of the privatization process, the state sector accounts for 75% of the actual GDP and the private sector for 25%.[21] Production by the private sector then rises by 25% a year and production by the state-owned sector falls by 10% a year. Under those conditions, the private sector will dominate production at the end of the fourth year. Privatization in the broader sense depends on the difference in pace between the two processes, and above all on the vitality of the private sector, not on how cunning a way can be found of transferring state-owned shares into private hands.

There are grounds for optimism in that. The course of privatization is not ultimately set by the wisdom or stupidity, the strength or weakness of Eastern European governments, opposition forces, foreign governments, international organizations, or advisers at home or abroad. At most, they may slow down or speed up the events. The process is directed by an irresistible inner force: the inherent motivation of the present and future private owners.

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21 This includes the second economy not considered in the official statistics.

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Summary

THE PRINCIPLES OF PRIVATIZATION IN EASTERN EUROPE

The paper surveys the choice criteria in selecting the mode of privatization. The main aspects are: 1. the sociological aspect with a longer time horizon, and in particular the objective to create a large class of business people; 2. economic aspects, and in particular the objective to increase efficiency and improve management; 3. political aspects and, 4. distributional-ethical aspects, including considerations of restitution and compensation for the loss of confiscated property. The paper discusses the role of the state and the evolutionary character of the privatization process, and analyzes various property forms. The significance of the evolution of personal owners gets special emphasis. Further subjects of the discussion are employee ownership, various forms of institutional ownership, give-away schemes of privatization and property rights of foreigners. Finally, the author explains his position concerning the speed of privatization.