

THE HERITAGE LECTURES

352

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By Stuart M. Butler, Ph.D.



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All over Central and Eastern Europe, millions of people live in the wrong place, go to the wrong job, and make the wrong things. In addition to reinforcing or creating a sense of private property in the region, the purpose of privatization is to rearrange the factors of production now used so inefficiently into a structure in which people live and work in the right places and make the right things.

Undertaking the necessary degree of privatization in Central and Eastern Europe is an enormous and complex task. The scale of the task is daunting and the political problems staggering. But privatization must be accomplished swiftly if the countries of the region are to move towards democratic capitalism without huge short-term economic costs. It is for this reason that the experiment in what one might call "mass-production privatization" now being launched in Poland and Czechoslovakia is of such immense importance, not just to those two countries but to all the countries and republics of the collapsing eastern Soviet bloc.

Consider the scale of the privatization task. In 1985 the state-controlled sector in the United Kingdom accounted for about 11 percent of the economy. In Poland, however, the proportion was 82 percent, while in Czechoslovakia it was 97 percent. During the 1980s, the U.K. attracted worldwide attention because it undertook a privatization strategy of historic proportions. Yet in eleven years Margaret Thatcher privatized only twenty major firms, representing about 5 percent of the economy. By contrast, in Czechoslovakia and Poland there are thousands of major firms that must be shifted to the private sector, and in the former Soviet Union there are tens of thousands. Thus, it is perhaps understandable that the privatization ministers in Prague and Warsaw say bluntly that the British model is of virtually no use to them.

Urgent Task. Consider also the urgency of the task. Private ownership is the cement holding democratic capitalism together. Moreover, major firms in Central Europe are in a twilight zone between communism and capitalism. Managers lack the crude central direction of a command economy that at least told them what to do, and yet managers also lack the incentives of a market economy. Thus they are subject to perverse incentives to become even more inefficient and to run down the assets they control. With eventual bankruptcy a probability in many instances, and with the future in any case so uncertain, managers and employees of these firms have tended to focus only on short-term benefits, such as giving themselves huge wage increases, and selling off stocks rather than investing for new production. In many instances managers and workers are engaged in the wholesale looting of their firms. Thus the positive incentives of private ownership and a market system must be applied to these companies as quickly as possible.

What has been the progress so far towards privatization? Understandably the greatest success has been with small firms, or at least firms that can be sold to one purchaser. In Poland the government claims that about 80 percent of the retail sector, 50 percent of transportation, and 40 percent of construction has been transferred to the private sector. The privatization of small firms in Czechoslovakia also has been proceeding apace.

The process has been far slower, however, in the case of larger firms. In all the countries of Central Europe, British-style one-at-a-time privatization has only limped along, and in some cases virtually ground to a halt. There are several reasons for this.

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He spoke at the 1991 regional meeting of the Mont Pelerin Society, held in Prague, Czechoslovakia, on November 5, 1991.

ISSN 0272-1155. ©1991 by The Heritage Foundation.

One reason is that there is no way to measure—or even to guess—the value of large, sophisticated firms. Because they have existed in a regime of artificial prices, enormous subsidies, and Kafkaesque regulation, there is no way to determine their market value using normal accounting principles. That is why so many Western investment bankers have been charging large amounts of money to conduct evaluations and yet have produced figures that are literally meaningless. We know that some of the firms are valuable, and we know some of them are junk. The problem is we don't know which is which. That makes finding a buyer at a reasonable price rather difficult.

The second problem with British-style privatization is that the privatization agencies simply are overwhelmed by the numbers of sales they must conduct. Throughout Central Europe, the process is in gridlock. That has led in turn to widespread “spontaneous privatization,” in which desperate privatization agencies have been forced to accept takeovers by existing managers with virtually no payment. In effect the agencies stand by powerless as massive looting takes place.

Third, there are competing political pressures that make privatization even more difficult and uncertain. In Czechoslovakia, for instance, political pressures mean that the privatization strategy must be linked to a policy of restitution. There is also a desire by reformers to create a strong middle class. Moreover, some of the easiest methods of privatization, such as allowing worker buy-outs, conflict with basic notions of fairness. Thus the methods of privatization that might be used, were the objective only to shift firms to the private sector as quickly as possible, cannot be used because of other political concerns or goals.

Fourth, the region lacks the basic financial institutions and legal framework that make large-scale privatization so much easier in the West.

It is to cut the Gordian knot represented by such problems and limitations that the Poles and Czechs have introduced the radical innovation of privatizing through free distributions of shares in the state sector.

This innovation is an attempted dash to the free market by dramatically increasing the volume of privatization. It is a drastic step with uncertain consequences. As the London *Economist* has described the strategy, “Free distributions are desperate acts to solve desperate problems.” The aim is to change the politics of privatization, accelerate the speed of transfers, and to achieve far broader political objectives than simply reducing the size of the state sector. In short, free distributions are the public policy equivalent of a parachute drop behind enemy lines. And as any military expert knows, a mass parachute landing can have one of two effects. It can change decisively the course of the entire battle in one's favor. Or the paratroops can be wiped out.

The risks of the innovation underway in Poland and Czechoslovakia are enormous, the potential benefits equally significant. There are also certain important differences in the approaches used in the two countries. In Poland, the population will receive free shares in a set of mutual funds. These mutual funds in turn will gain title to most of the state sector. In Czechoslovakia, by contrast, the population will receive vouchers with which they can purchase shares in individual companies.

Each of these approaches has potential benefits but also major risks.

Mutual Fund Strategy. In Poland, the government is essentially trying to privatize the very process of privatization. It will rely on the mutual funds to undertake the massive task of reorganization that in British-style privatization generally occurred before the change of ownership took place. This has two advantages. The first is that it speeds up the transfer process by allowing major private agencies to undertake the massive task of valuation and restructuring now suffocating state privatization agencies. The Poles intend to speed up this process further by bringing in some foreign managers to help operate these mutual funds. The second advantage is that the reorganization itself will be market-driven because it will take place in the private sector and by organizations operating under the incentives of the market system. Thus the reorganization is more likely to result

in an efficient outcome than would be true if the government attempted to reorganize firms before selling them.

But obviously there are also great risks in the strategy. These huge mutual funds in Poland will have great economic and political power. They will have a strong incentive to engage in what economists call “rent-seeking,” that is, they doubtless will attempt to extort political and financial favors from the government. One can imagine, for instance, that if a mutual fund is faced with the prospect of widespread bankruptcies and layoffs among its portfolio of firms, it might use the political impact of mass unemployment in affected communities to win subsidies from the state. On the other side of the coin, the state itself may use regulations and subsidies applied to the mutual funds to try to micromanage the private sector as part of an industrial policy.

Voucher Program. The Czechoslovak voucher program, by contrast, has the virtue of allowing people to invest directly in individual companies, rather than in a holding company. Thus the Czechs will have a sense of real ownership that the Poles probably will not. On the other hand, will these individual shareholders have enough knowledge and clout to force a change of management, or to press existing managers to behave in a more efficient manner? It is not clear that they will. To be sure, the Czechs have encouraged the emergence of brokers and mutual funds to act as Western-style intermediaries in the share-owning process, and these can be expected to have a significant impact on the management firms. Thus, the Czech government has sought to provide leverage for individual shareholders. Still, it is an open question whether this will be sufficient to offset the inside information and inherent power possessed by existing managers.

So what will be the results of the remarkably innovative form of privatization represented by the Polish and Czech governments? Before making any judgment on the strategy of free share distributions, one must recognize that the issue is not which method of privatization is guaranteed to be successful, but which one that is more likely to succeed than the others. In this context, I suspect that the Czech and Polish approach may turn out to be, as Churchill said of democracy, “the worst system except for all the others.” It will certainly be chaotic. Mr. Triska, the official conducting the Czech voucher system, has remarked, “It will be like the Wild West.” He is right. And the factors influencing the privatization process are much too complex for an outside advisor even to attempt to disentangle. Given that, the advice of outside privatization experts may not be of much use to the Poles and the Czechs. The best we can say perhaps is, “Good luck!” Now, that advice may not be of much help, but at least it is honest. And it is free. So it fits with Czech Finance Minister Václav Klaus’s dictum, “Don’t pay hard money for soft advice.”

Two Caveats. Yet while it is unwise for outside observers like myself to offer much advice on your voucher program—even if we don’t charge you anything—we can perhaps offer two important caveats about privatization.

The first is that you must pay close attention to the privatization of housing. As I mentioned at the beginning, most Czechs and Poles live in the wrong place. That is because rents and construction have been highly controlled—and generally still are. As massive restructuring takes place in the economy, there will be heavy demands for labor in some places, and there will be huge layoffs in other places. If there is not to be enormous unemployment in some cities, and chronic shortages of labor in others, labor must be as mobile as possible. The immobility of labor is one of the most damaging legacies of the command economy and could make reconstruction extremely difficult. Thus, you must take urgent steps to free up the housing market. Even more important, you must take action to privatize the construction of new homes.

The problem, of course, is that housing is a very sensitive political issue. It is very hard to conduct a swift privatization strategy with controlled rents. The long process of restitution now being undertaken in Czechoslovakia also makes it hard to deregulate housing. But if you do not tackle

this with the sense of urgency and with the bold innovation you have demonstrated in the privatization of companies, there will be long-lasting problems. I suspect the best course would be to move as quickly as possible to establish clear ownership rights for vacant sites on which new buildings can be erected, and to institute swift permitting procedures for construction as well as the rapid privatization of the construction industry. That at least will allow new homes to become available where new workers are required. Dealing with rent control can come later—we in the West have not even solved the political problems associated with decontrolling rents.

The second point I would emphasize is that prosperity comes from new enterprises, not from re-arranging old ones. The evidence is overwhelming that new jobs and new wealth come disproportionately from new ventures, not from efficiency improvements in existing firms. Thus while the privatization of existing firms is extremely important, that should not become an obsession at the expense of instituting tax, regulatory, legal, and monetary policies to spur the creation of new firms. The fact is that most of your existing large firms are junk. The more quickly these can be broken up and their assets made available to new entrepreneurs the better. The economic landscape in five years will be completely different from today's. Such creative destruction is the sign of a strong economy. In the West, there is a big enough turnover of enterprises. Here in Central Europe you can expect the turnover to be even greater in the short and medium term. Thus you should understand that privatization is simply part of the creative destruction and formation of enterprises that is life blood of capitalism. Do not make the mistake of thinking that privatized industrial dinosaurs will be the cornerstone of a vibrant market economy.

Beneficiaries to the East. Finally, let us consider who has most to gain or lose from your gamble to accelerate the process of privatization? When it comes down to it, while academics and advisors such as myself have an emotional stake in what you are doing, ultimately the experiments in Poland and Czechoslovakia simply will go into our inventory of case studies for future use. We will not have to live with the results. For you here in Czechoslovakia, and for the people of Poland, the impact will be more personal. However, a walk around Prague indicates clearly that the chances are you will come out of all this with a strong private market and a free society. It may be a long road, and you may take some wrong turns, but you will get there. And if your privatization innovation does not live up to expectations, or even if it fails, it will only mean a delay in your journey.

Yet the people who in fact have most to gain or lose from your bold privatization gamble live many miles to the east. In the remnants of the Soviet Union, the problems of transition make your difficulties appear as nothing. Thousands upon thousands of firms need to be privatized. Some economic purpose has to be found for a huge military/industrial complex. A despondent and jittery military needs to be demobilized and integrated into the private sector. And while for Czechs and Poles there are still strong memories of an economic system based on private enterprise, most residents of the former Soviet Union have little inkling of what a market really means and how they should behave in it. It is they who have most to gain or lose from your innovation in privatization. For their sake, I hope your experiment works.

