Stated Meeting Report

Privatization: The Great Problem of Transition in Eastern Europe

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Transition in Eastern Europe has many dimensions. For example, its goals include putting an end to inflation and restructuring the economy. These are issues I will not discuss tonight. Instead, I will talk only about the segment of transition related to ownership—and let me emphasize that that is only part of the issue. Privatization has two different meanings—a narrow one and a wider one. The narrow one involves the understanding that we have to shift the ownership of formerly state-owned assets into private hands. The wider meaning of privatization concerns what the role of the private sector should be within the economy as a whole. I will use this wider interpretation; I will not limit my comments to the future of the formerly state-owned enterprise. Also, although the title of my presentation refers to Eastern Europe, most of my remarks can also be applied to the Soviet Union. And, of course, each Eastern European country is different. Each has its own history and its own problems and will go its own way. The current situation in the Soviet Union is very much different than that in Hungary or in Poland. I would like to focus on problems that are common in that region; it will not be possible, in this relatively brief talk, to cover the differences country by country.

What is the purpose of the privatization effort? There are now hundreds of schemes and proposals for change of ownership. Each party in Eastern Europe has its own program; sometimes even each faction within a party has its own proposal. Every economist, every foreign advisor, every foreign visitor has a scheme for what to do in Eastern Europe. I will not have time to spell out the objectives of the various proposals for privatization schemes, but I would like to summarize the controversial issues surrounding privatization (throughout Eastern Europe and among Western advisors, there is no consensus) and to discuss my own positions on those issues.

I would like to start not with the economic aspect of privatization but with the social transformation aspect. What has been going on in Eastern Europe lately is not simply a change in the economy but a change in the society as a whole. With some oversimplification, one could say that before certain recent dramatic events, the typical Eastern European socialist economy was controlled by a pyramidal bureaucratic hierarchy and that state ownership was predominant. There was little or no place for private ownership. My own country, Hungary, was somewhat of an exception in that it already had some private ownership and some private sector. But in most other Eastern Europe countries, and certainly in the Soviet Union, that was not the case. I think that the main objective of privatization is to change the social structure and to establish a business class. The social stratum of people with small and medium-size businesses—a group that represents millions of people in Western countries—didn't exist in Eastern Europe.

In addition to the complementary processes of involving a large number of people in business and decreasing the role of the state, there are economic objectives to change of ownership. The main goal is to give people stronger incentives to work and to encourage better management. State ownership couldn't enforce efficient financial discipline or work discipline over enterprises dominated by impersonal, intangible bureaucratic ownership. Privatization may also bring revenues to Eastern European governments, which are in big fiscal trouble.

Privatization has political objectives as well. This issue came up in the recent Polish electoral campaign; privatization can help diminish social and political tensions. Finally, change of ownership has ethical aspects. Here I must comment on the big controversy over equal distribution of formerly state-owned assets. There are many advocates of schemes that would give away claims to state-owned assets free of charge, and they suggest an equal distribution to citizens. I am very skeptical that this would be advisable. I fully respect and understand the demand for equity; that is an important aspect of all economic decision making. But there are many other instruments that may, will, and should be applied toward achieving equity. I don't think that you can start markets or give impetus to private businesses under the banner of equality. Given existing conditions, private means—money, cash, bank deposits, and, more important, knowledge and information—are unequally distributed. No strong equalizing effect can be achieved by giving away a tiny bit of shares to every citizen.

Let me turn now to the role of the state. I'm not talking about the role of the state in an economy in general terms. That broad subject could be the topic of a lecture in its own right. I'm talking only about the role of the state in the process of privatization. I am convinced that the state must and should play a certain role, but you cannot rely on it to do the entire job. The opposite plan could be assured by the state. The politburo in the Soviet Union made decisions in the 1930s to liquidate the kulaks; that is the sort of thing that can be decided by the top leaders of the country. But those leaders, together with a bureaucracy, cannot decide that they want to create a class of rich farmers. Such a class cannot be created; it must evolve. Similarly, confiscation of property in the cities can be done by bureaucratic means, but the establishment of new, privately owned businesses can come about only through an evolutionary process. I recently read an essay in which the term *etatist liberalism* was used in an ironic way (interpreting *liberalism* in the Western European sense, not in the American sense). The author's point was that you cannot hope for free entry, voluntary contracts, and the entrance of new entrepreneurs and expect to bring about these changes by bureaucratic central decisions. I am speaking from the perspective of Eastern Europe, where right now, in many countries, huge ministries and huge offices exist for the sake of privatization. I'm not very hopeful that privatization can really be widely and sufficiently inspired by central bureaucratic organization; it must be launched by the voluntary undertakings of individuals who want to become entrepreneurs, who want to become businessmen, who want to open new shops or start business ventures. The state's role is to remove obstacles, to remove impediments to this process. It can speed up the process with appropriate monetary and fiscal policies, but it cannot do the job. I do not think that a change in the texture of society can be generated artificially by bureaucratic decisions, as many politicians and some state economic advisors suggest.

The next issue I want to mention is the problem of speed. Usually, when a foreign visitor or a foreign journalist meets with somebody from the government or academic circles of Eastern Europe, the first thing he or she asks is "Are you for a gradual transformation or a one-stroke transformation?" I think that's the wrong question because it assumes that there is an average speed for all these changes, and that is not the case. The transformation process is a complex, manifold, multidimensional change; some parts of it may move quickly, but other parts will not. It is not simply a matter of whether one wants the process to occur quickly or slowly but a matter of what is feasible. What can be done quickly is practically outside the topic of my lecture today. Anything that can be decided on a governmental level, including some very important measures, can be done quickly. For instance, quick, strong measures against inflation or for introducing convertability can be adopted. These are important changes, and I am in favor of their being made, after careful preparation, quickly and with a very strong hand. But the transformation of society cannot be commanded. That process is inevitably slow. It can be speeded up, but anyone who thinks it can be done overnight or through some clever quick-fix privatization scheme is operating under an illusion. To learn how to behave in a market takes time; it's a trial-and-error process. The natural selection of institutions and organizations is a process that takes years; it can be speeded up, but I don't believe in quick-fix miracles.

Let me turn to the main trends we can observe in the transformation process. Any program of privatization—whether a program in the Soviet Union, or the program of the Hungarian government or the Hungarian oppositional parties, or that of one presidential nominee in Poland or the other—can ultimately be broken down into three main elements. The first is personal ownership, the second is employee ownership, and the third is institutional ownership. There are advocates of each of these alone, and there are those who promote combinations of various proportions of the three trends. More or less everything now under consideration belongs to these three elements; almost nothing is outside of them. Of course, there is controversy over how much of the state-owned sector should remain state-owned. There is also a more general issue: If you start with 98 or 95 percent state ownership, should 10, 20, 30, or 40 percent remain state-owned? Almost everyone agrees that some state ownership will be needed. Most people agree that for the time being, public utilities and transportation (e.g., railways) should remain state-owned, as well as a large part of the education system. That is not very controversial. The hot issue in the debates is what kind of private ownership to work on.

Let me start with personal ownership. One example of what I mean by personal ownership is the operation of a privately owned small or medium-size family farm, where the owner is the manager and the family members do all or most of the work, perhaps with occasional help from hired labor. Another example would be a family-owned or family-managed urban business—or perhaps a new enterprise initiated by an entrepreneur who borrows some venture capital from a bank or gets some capital from an investor. Another example would be a large joint-stock company, provided that there is a core shareholder—one highly visible individual or group of individuals who initiated the company or took it over, who perhaps own only 20 percent of the shares but have dominant control over how the company is run. One can read about many such cases in the business press. One more example of personal ownership is a managerial buyout, in which managers take over their firm. My examples have different legal forms: some are corporations; some, such as farms, are not incorporated. There are small, medium, and large enterprises. What makes them similar is that certain living persons have much at stake—individuals with not only a strong incentive to make a profit and to do good business but also with the power to enforce their will. Everybody in Eastern Europe agrees that this kind of ownership is needed. The disagreement concerns the relative importance of it. Some people belittle this part of the transition program, saying "Okay, it can go on, but it's not terribly important." I'm convinced, however, that it is the most important part right now. I don't see that this will be the case five or ten years from now, but right now the bureaucratic economies of Eastern Europe need huge doses of individuals who want to be entrepreneurs, who are ready to take risks, for whom the market is an attractive environment. That spirit has been eliminated in Eastern European countries; they need to bring it back. This will take at least a few years. They can be a large and dynamic part of what are now ossified and bureaucratic state economies. There are many areas in which there is an extraordinarily important need for private entrepreneurial activities—for instance, services, the financial sector, and domestic and foreign trade, which are all now dominated by rigid state organizations. They are ignored; we read about them in the speeches of politicians, but there is little action to help them. In Poland and Hungary, for example, maybe 2 to 3 percent of the total credit supply for the economy as a whole goes to the private sector. That must be changed.

The second trend I mentioned is employee ownership. That has some strong support among blue-collar workers. It now has some history in Yugoslavia and already has some tradition and legal framework in Poland and Hungary. There are enterprise councils, or workers' councils, with certain legal powers in state-owned enterprises. There are employee-owned enterprises all over the world, but they are typically a small segment of the economies in which they function. The question is whether after 95 percent state ownership, government decree should mandate 95 percent employee ownership. Should factories simply be handed over to their employees? That idea has some support among certain political movements, but I think it has disadvantages. It wouldn't help reach the objectives I mentioned at the beginning. It wouldn't ensure the right economic incentives; on the contrary, it would strengthen pressures for wage increases, which can fuel inflation. It would impede the mobility of capital and labor. But there can be some ethical justification for a modest share of employee ownership in each company; it can help ease political tensions. I would support the idea of, say, 10 to 15 percent employee ownership in a formerly state-owned enterprise. But handing over 100 percent of ownership to the employees would mean that some of them would be very happy because they had inherited a good enterprise, and some would be very unhappy because they had inherited the debt of a poorly working enterprise; it would not mean fair distribution.

The third trend is institutional ownership. Again, there are many variations. Of course, institutional ownership has a very important role in capitalist countries. Much depends on what kind of institution we have in mind. If you go to an Eastern European country, one idea that always comes up is giving shares to the pension funds. In this country pension funds are among the most important owners of enterprise shares, and they are responsible owners because they have long-term interests. The problem right now in Eastern Europe is that there is no such thing as pension funds in the plural; there is only the state social security system, which is a branch of the same government that runs the economy and has had, until now, a monopoly on pension arrangements. To give shares of the formerly state-owned enterprisees to this bureaucracy-monopolized pension fund would simply be to take ownership rights from one pocket of the state and put them into another; it would have nothing to do with decentralization of ownership. That process should start with the decentralization of the pension system. A very smooth and careful transition to a pension system that is partly public and partly private will not lead to the state's withdrawal from its obligations to certain pensioners, as long as a clear distinction is made between those still young enough to opt for their own pension and those who are older and stuck with the state-owned pension. In this evolutionary process, successively more and more pension funds become private. Governments could help the evolution of private pension funds by providing initial capitalization in the form of shares of formerly state-owned companies. Pension funds serve in this talk as an example of potential institutional owners. It could be said, in more general terms, that institutional owners who are able to take good care of property must evolve and emerge, must learn their new role and get used to it; after some time, their role in the economy will increase.

Some economists are for a much quicker solution. I heard a lecture given by someone who advises the USSR to create, practically in one year, about twenty mutual funds, to give all state-owned enterprises to these mutual funds, and to give the shares of these mutual funds to the whole adult Soviet population of 250 million. I do not think that is a feasible solution, something that would ensure better incentives or solve the problem of improvement; it is a bureaucratic solution of the privatization issue. I am much more in favor of a more natural growth of institutional owners, urged and supported by sufficient, appropriate legislation and government measures.

The three trends I have discussed are to some extent complementary and can be implemented side by side. First of all, the public and private sectors can coexist. Within the private sector there can be small, medium, and large businesses, corporate and noncorporate businesses. Some shares can go to employees, some to institutions, some to individuals who buy them. But I don't want to deny that there is also rivalry for fiscal favors—for example, whether the various forms of businesses should be uniformly taxed, or whether some should be entitled to certain tax exemptions. I've already mentioned the problem of rivalry for credit. The more credit is granted to one business, the less can be given to others; therefore, choices must be made as to which should get more and which should get less. There is also a rivalry for the attention not only of the public but also of the government, and that is very important. A parliament has a certain legislative capacity; it cannot legislate everything. Government's hands are tied when it comes to many tasks of transition. Right now, I'm afraid, too much attention is being paid to what to do with state-owned assets, and too little attention is being paid to the concept of the evolution of a new middle class, a new business atmosphere, a new business climate. I think a shift of at least some attention and efforts is called for.

Many Western observers would somehow simply transplant a Western-style economy into Eastern Europe. The problem with that is that conditions in Eastern Europe are absolutely different from those here. Many things that Westerners consider self-evident or take for granted—for example, the effects people seek in terms of gain and profit, what people think about prices and costs, about buying and selling assets—are seen only as possibilities for the future in Eastern Europe. Many people there don't like the inevitable level of inequality associated with Western-style economic changes; to them, such changes smack of speculation and profiteering. What is needed to alter this frozen bureaucratic atmosphere is a huge injection of entrepreneurial spirit.

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