THREE years after the systemic changes sweeping the political and economic landscape of Eastern Europe, privatization is still widely talked about and seemingly pursued. Yet, despite ardent support for the concept, not much privatization is actually taking place, and what does occur is often much more ambiguous than originally expected.

The enthusiasm for privatization that characterized the first period of postcommunist reforms was somewhat surprising to many observers familiar with the Eastern European environment. For if the communists had any success in their attempts at ideological indoctrination, it was in persuading many Eastern Europeans that private property in the area of large industry was a thing of the past.

What most oppositionists argued for—and it should be remembered that much of the opposition in the last years of communism came from worker movements, such as the Polish Solidarity trade union—was decentralization, with at most a marginal role for private property outside retail trade and the service sector. And yet, following the collapse of communism, privatization became the word of the day, and many influential East Europeans became, at least on the surface, the most ardent proponents of the purest version of capitalism.

Three years later, privatization is still talked about and seemingly pursued, but the results are mixed. It is too early, of course, to judge the effects of privatization where it actually occurred, but it is not too early perhaps to observe that not much of it is occurring in most places, and that what does occur is much more ambiguous than originally expected.

In the broadest sense, privatization should be understood as a transfer of assets from the state to the private sector, accompanied by a radical reallocation of available productive resources, restructuring of the existing institutional setting in which production takes place, and the introduction of new methods of corporate governance, freed from the most noxious kinds of political interference. While privatization in this sense could be expected to lead to far-reaching economic and social transformations, a mere transfer of title is unlikely to have such an effect. Indeed, it may sometimes be doubted whether, under the conditions of many postcommunist societies, it leads to any genuine structural changes or even to a meaningful modification of legal ownership.

**Small privatization**

Privatization, where it has occurred, has been the most effective in retail trade and the service sector. But the nature of this phenomenon only highlights the complex meaning of the term "privatization." Most stores and service outlets in Eastern Europe hardly resembled their western counterparts: the constant shortages meant that their inventory was not worth very much, and their standard services did not create a great amount of valuable "goodwill." What these stores and outlets did have was valuable premises that needed to be reallocated to better uses.

In this context, it is interesting to note that, in most cases, the "privatization" of the retail sector did not entail a transfer of the ownership right to the premises; instead, the state retained the title and the premises have been most often merely leased for relatively short periods of time, often with no secure right to renew and a number of burdensome restrictions. It is thus difficult to decide whether to count the new units operating in the premises as "new" or "privatized" establishments. What is quite clear, however, is that the partially released real estate assets have often been used effectively by the private businesses now controlling them. The vibrant private sector in this area is quickly transforming the provision of goods and services in a number of countries in the region. What is also interesting is that, once a significant private sector appears, the success of further transformation in the trade and service area may depend as much on the change in the general economic environment (including monetary stabilization, currency convertibility, and price and trade liberalization) as on the completeness of the privatization itself. Indeed, the most successful transformation has perhaps occurred in Hungary, where genuine privatization has made only limited progress.

Part of the reason why “small privatization” has been a relative success in some countries is that it raises few of the hugely complex corporate governance problems endemic in all efforts to reform larger industries. The privatized shops and service outlets are usually owner-managed, and the low capitalization requirements make for a potentially lively secondary market that is able to correct for many mistakes in the initial allocation. For this reason, it may not be particularly important whether the state turns over the running of small businesses to workers (as is most commonly the case) or whether it sells them to the highest bidder in an open competitive process (as was the case in the former...
Is the State Withering Away?

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Czechoslovakia), so long as there are no crippling transferability restrictions on the privatized assets.

The failure of sales
The situation is more complicated in the case of larger industries, where privatization encounters serious technical and political obstacles. The initial difficulty faced by the state, if it wants to withdraw from ownership, is the need to find and empower new owners. The first instinct of Eastern European policymakers and their western advisers was to avoid any experiments and follow well-known precedents, such as the British-style privatizations, which involved selling shares to the public or to a selected number of private investors.

For reasons that are by now too well known to recount in detail, the attempts to emulate western privatizations were, by and large, a failure. With a few notable exceptions of sales to foreign investors (mostly in Hungary and the Czech Republic), few Eastern Europe enterprises have in fact been sold to outside private investors because of the unattractiveness of investment in Eastern European state enterprises, the slowness of the process, the problems of valuation, the shortage of domestic capital, and the unwillingness of foreign investors to enter at a large enough scale. Whatever sales were actually made in Eastern Europe usually involved complicated deals by which enterprise insiders forced the state to relinquish some of its property rights in their favor.

Hungary exemplifies this type of development, where a decentralized and loosely controlled process of transformation of state-owned enterprises resulted in a Byzantine system of institutional cross-ownership, with (still largely state) companies and banks holding stakes in each other. While the reform of the Hungarian economy is often viewed as the most advanced in the region, a very small proportion of large Hungarian enterprises is actually privately owned; according to most local estimates, the aggregate private holdings of previously state-owned assets amount to about 10 percent of the total. But even the state, despite its lion’s share of formal property rights, is not a clear owner of the remainder of nonprivatized assets. The maze of institutional cross-ownership, multiple layers of holding companies, and special arrangements put in place by the managers make it difficult for any party, even the state, to effectively assert ownership or rights. Somewhat paradoxically, the sales-driven transformation of the Hungarian economy not only did not result in a large-scale privatization but may also have hampered the emergence of a clear system of property relations.

Mass privatization
Given the inherent limitations of sales as a method of privatization in Eastern Europe, a number of governments in the region turned to what appeared to be a more promising avenue: various forms of giveaways, designed to combine a speedy transfer of ownership with a measure of social justice and a chance to secure political support for privatization among the broad masses of the population.

Chance and design in the Czech experiment. The most advanced, and the most successful, of all such “mass privatization” programs has been in the former Czechoslovakia. The plan involved a distribution (for a nominal price) of special vouchers to every interested citizen. The recipients could then use their vouchers to bid for shares of a privatized enterprise of their choice or deposit them in an intermediary financial institution (an “investment fund”) offering greater investment expertise and diversification. On the supply side, each enterprise, as well as any other interested party, could propose a “privatization project” specifying the method of disposition of the shares of the privatized enterprises, including some combinations of voucher sales, trade sales, and sales to enterprise insiders. In a coincidence that may have been crucial to the plan’s success, enterprise insiders often proposed that a very large portion of the shares be sold for vouchers, apparently in the belief that dispersed public ownership would facilitate the retention of insider control. At the same time, spurred by rather irresponsible promises of spectacular returns on the part of many investment funds, over 70 percent of the voucher recipients decided to place their vouchers with the funds. As a result, while the choice of the voucher route of privatization led to a very speedy transfer of title, the plan also produced a significant concentration of ownership, giving rise to a hope that the new owners will exercise effective control over the management of the privatized enterprises.

The Czech plan, with its large measure of external control over the newly privatized
Elusiveness of property rights: the case of Russia. According to the Russian plan, every citizen receives, free of charge, vouchers with the nominal value of 10,000 rubles. The plan contains a number of features, including immediate and unlimited transferability of all shares and vouchers, which seemingly facilitate the acquisition of control by enterprise insiders. But the program also offers insiders unprecedented preferential terms, allowing them to acquire up to 51 percent of their companies at 1.7 times book value unadjusted for inflation (which, together with the use of vouchers, makes the insiders' share close to free). Furthermore, Russian law prohibits investment funds from owning more than 10 percent of the shares of any one company, thus effectively confining them to a subsidiary role in the governance of the privatized enterprises.

What, then, is the meaning of the term "privatization," as applied to the (still very recent) Russian experience? Evidently, the authors of the Russian plan believed that removing assets owned by the state from the control of the old branch ministries, with their roots in the planning system and the bureaucratic nomenclature, was of critical importance to the progress of the reforms and worth significant compromises in terms of the openness of the property system and the role of external control in the future corporate governance structure of the country. They also believed (with reason) that the introduction of a more open system, modeled on the Czech program, was not a politically viable option in Russia. As a price of being able to push through their program, therefore, the government was compelled to grant insiders an initial right to maintain, and sometimes strengthen, their hold on the enterprises. This hold is now formalized under the name of "ownership," but apart from some relaxation of bureaucratic control by the old branch ministries, the practical meaning of this new arrangement is not fully clear. Except for the possibility that insiders may sell their control rights in the future (which, as we shall see, is somewhat problematic), the people in charge of the enterprises are largely the same after the change as before, and the question is whether their incentives are changed significantly enough for a restructuring to take place.

The program seems to strengthen the role of the workers, who are more interested in maintaining employment than maximizing profits, since wages are likely to be significantly more important to them than dividends. The managers, especially in the less viable enterprises, are also likely to view the continuation of state subsidies, rather than the costly and controversial restructuring, as their dominant goal, although there is some hope that the managers of the more viable enterprises will show some interest in breaking away from the old mold.

Overall, the possibility of insiders alienating their control rights and outsiders gaining significant voice in the running of privatized enterprises offers the prospect of more decisive changes in the governance and functioning of large Russian enterprises. Indeed, the authors of the Russian program evidently hope that secondary markets will develop quickly enough to permit subsequent corrections in the initial distribution of ownership rights, with the workers in particular cashing in early on their substantial capital gains. Unfortunately, there are some reasons to doubt that secondary markets will be able to play such a role in the near future.

The most serious obstacle to the creation of viable secondary capital markets in Russia is the potential lack of demand for the shares of the privatized companies. There are two reasons why a potential outside investor may acquire shares of an enterprise: to participate passively in the future income streams generated by the enterprise (through dividends or stock appreciation), or to acquire control of the firm and realize special profits due to entrepreneurial activity. In the conditions prevailing in Russia, however, it is not clear that an outside investor can expect to achieve either of these two goals.

The main reason why firms in capitalist economies must meet their commitments to outside minority investors (who do not have the power to control the firm) and respect their right to participate in the income streams produced by the firm is because the firm needs to generate capital. If the firm does not make a credible commitment to outside investors, its access to capital markets will be closed. Under current Russian conditions, however, the financing of large enterprises is done largely through the banks, which extend extremely generous credits backed by the close-to-unlimited printing capacity of the central bank. In this situation, until a credible stabilization program introduces greater monetary discipline and hardens the enterprises' budget constraint, insiders have every reason to distribute any profits of the enterprise in the form of wages, bonuses, and other compensation to themselves, rather than paying them to shareholders. Thus the system creates strong disincentives for outsiders to take stock positions in Russian enterprises.

The incentives for outside investors to acquire control positions in the privatized Russian enterprises are also problematic. To begin with, large concentrations of capital necessary for takeovers of large firms are not likely to exist for some time in any East European country. But even leaving this aside, there is a risk that the Russian state may not be able, at this time, to provide sufficient protection of property entitlements and to realistically enforce the right of significant external stakeholders to assert their effective control of large Russian enterprises. This risk is especially likely if an assertion of external control rights over a significant proportion of Russian enterprises were to lead to a threat of large-scale unemployment and labor unrest. Faced with such a prospect, the state is likely to step in to curtail, or even revoke, the control rights of the outside investors in order to prevent significant social dislocations. But this lack of credibility of the state's commitment to the enforcement of property rights is, in turn, likely
Three early lessons

More generally, three tentative conclusions can be formulated on the basis of the first three years of the privatization experience in Eastern Europe.

First, the meaning of “privatization” in the context of Eastern Europe has turned out to be complex and often ambiguous. Instead of the expected clarification of property rights and the establishment of a system of economic incentives characteristic of a capitalist society, the intended privatization process has so far resulted in a maze of complicated economic and legal relations that may sometimes even impede a speedy transition to a system in which the rights of capital are clearly delineated and protected.

Second, the conflict between the interests of insiders, intent on retaining authority over their enterprises, and the right of outside investors to acquire control, has consequences that are often overlooked. While much attention has been devoted to this conflict, it has usually been analyzed in terms of the special historical and political conditions of Eastern Europe and in terms of the standard incentive problems associated with insider control. What is worth drawing attention to, however, is that insider control and barriers to the entry of outsiders may also retard the development of a system of clear property rights, including the rights of the insiders as owners of capital.

Third, there appears to be a hitherto unrecognized connection between the absence of monetary stabilization, with the associated soft budget constraints at the enterprise level, and the absence of a clear system of property rights to capital. By weakening the commitment of firms to fulfill their promises to the providers of capital, soft budget constraints contribute to a situation in which the rights of the owners of capital cannot be firmly established.

Seventy years of communism have not resulted in the predicted “withering away of the state.” Perhaps not very surprisingly, the elimination of the inherited hypertrophy of the state in the postcommunist economies of Eastern Europe is also proving to be much more difficult than originally expected.