Volume 12
Number 3 *FOURTH ANNUAL ERNST C. STIEFEL SYMPOSIUM: THE PRIVATIZATION OF EASTERN EUROPE*

Article 2

1991

PRIVATIZATION IN EASTERN EUROPE: IMPRACTICAL, BUT NOT IMPOSSIBLE

ANDRZEJ RAPACZYNSKI

PRIVATIZATION IN EASTERN EUROPE: IMPRACTICAL, BUT NOT IMPOSSIBLE

ANDRZEJ RAPACZYNSKI *

The most important thing that must be understood by anyone thinking about Eastern European privatization is that the word "privatization," although correct, is somewhat misleading. It is misleading because it brings to mind the operations performed in many other countries where state-owned companies have been sold to private individuals. It is very important to understand that the significance of privatization and the practicality of privatization in Eastern Europe are quite different. The most important thing is that the main task of privatization is not to transfer ownership from one party to another—like that successfully done in England—but rather to create a market economy. This is something very new, whereas privatization in England relied on the existence of market institutions.

State companies that the British government privatized operated within a system of free prices. One could easily trace past income from their books. They operated under a scheme that required their books to reflect real costs and revenues. There was a proper accounting system, which allowed analysts to get an idea of the health of the companies.

In comparison, the companies in the East were buying and selling at prices that were invented by some bureaucrat and, therefore, were not easily comparable to other countries. You cannot try to correct these prices by using the world-market price of a given commodity produced in the East, because with most products there is a different level of quality and different type of market. As a result, you do not know the health of a company when you examine its books. Moreover, the word "debt" has an entirely different meaning for the Eastern European companies. For example, sometimes forty percent of the value of the assets of a company are in the form of inter-enterprise debts, and one cannot determine whether this debt is collectable or not. Like the banking system, the firms were lending each other money and providing goods without payment or

* Professor of Law, Columbia University School of Law; B.A., 1968, University of Warsaw; M.Phil., Ph.D. in Philosophy, 1974, Columbia University; J.D., 1982, Yale Law School.

knowledge of which companies were solvent. Now, the chances of collecting the debt are small. And if one were to attempt to collect the debt, the system would collapse like a house of cards.

Let us look further. The first step in Western privatizations is to hire professional accountants to value the companies. In Eastern Europe there are no reliable domestic accounting firms, and the foreign firms that recently opened do not really know what they are up against because the books are in such poor condition.

The next step in a "normal" privatization is to hire an investment bank. However, in Eastern Europe companies were never bought or sold. There is no stock market. There is no market for privatization. The risks are incalculable because of the uncertainty of future earnings in an ever-changing domestic economy. The result is obvious: no investment bank will ever underwrite securities in these countries. Thus, the Western experience of privatizing a company is of no value.

In fact, privatization is supposed to create, for the first time, the institutions of a genuine market economy. Privatization will require most corporations to set-up institutions to keep proper accounts; set-up proper corporate structures; create incentives for management; an international market; a banking structure; and hard budget constraints. For these reasons, one cannot rely on traditional privatization methods.

The Thatcher government privatized twelve companies in eight years with great success. This was a very large section of the British securities market. But nevertheless, it was only twelve companies in eight years. Poland, on the other hand, has about 8000 state companies. In Russia, there are hundreds of thousands. Therefore, if you try to privatize these companies in the "traditional" way, the pure cost of buying these companies would be staggering—if you could even do it. The Polish government, under the misguided influence of foreign advisors, spent millions of dollars in accounting fees in the first year when it tried to privatize five companies. These foreign advisors engaged in all kinds of fantasies about what these companies were worth because nobody could get any facts. It is a little secret that in the end, state banks bought-out the shares of some of the companies because there were not enough takers.

Clearly, privatization in Eastern Europe is a very difficult process. Lessons have been learned and things have changed. However, the plain truth is that Western privatization methods are of little value to the Eastern European countries. It is true that these methods might be helpful if you could find foreign investors; those who would come in and buy raw materials, or a factory that would produce goods with easily determined world export prices. But the fact remains that the Western style of privatization will be of very little use for the transformation of Eastern

European command economies into market systems.

Some suggest that Western procedures should be simplified and rapidly applied as a quick-fix: forget proper valuation, sell it more or less at any price. This suggestion, however, will also fail. Poland is a suitable example. If we assume that every Pole would invest twenty percent of all his savings to buy shares of state-owned companies—an entirely unrealistic assumption since these corporations are terrible investments—this would account for only two percent of the aggregate worth of state-owned companies. Again, there is the problem of the worth of Eastern European companies; but if it is assumed that the official valuations are not entirely unreasonable, it is obvious that trying to sell state-owned companies to the domestic population is simply hopeless. Not only are there no markets, not only is it technically infeasible, but the money is not there. In effect, the government would be giving the stock away. Moreover, this form of give-away would be unjust because the government would be giving the companies to those people who could accumulate cash under the old system. Those who accumulated cash under the old system did so through either swindling or political subservience. Thus, the state-owned companies cannot be sold domestically, and the question becomes, "can they be sold to foreigners?"

Realistically, there are not a lot of takers for most of the state-owned enterprises. There is also a feeling in Eastern European countries that while it would be good to have foreign investors, it would be improvident to allow full ownership by foreigners. As a result, you have this schizophrenic attitude—on the one hand, you want money coming in, but on the other hand, if it turns out that the recently sold state companies are worth more than the "official" book value, a tremendous political fallout would result. Just imagine the Easterner's belief: Western investors are out to make a buck and they are here to control us forever. Realistically, without foreign investment, Eastern European economies cannot develop. But the climate for Western investment very often varies from hostile to moderate. Thus, some other ways must be found in order to transform a very large proportion of the state industry.

First, companies would not cause total economic chaos. One solution is to synchronize the collapse of the state sector with the rise of the private sector. This is in contrast to the big bang solution, which itself is problematic because it could conceivably cause forty-percent unemployment from one day to the next. Moreover, I assume that forty to fifty percent of the Polish economy would have to be scrapped. I am convinced that an even greater proportion of the Russian industrial enterprises must be scrapped. The consequences would be socially unacceptable.

On the other hand, synchronization, industrial policy so to speak, may not be any better, because there is no reason to believe that the quality of government services in Poland, Russia, Czechoslovakia, or Hungary is any better—my experience is that it is probably worse. Obviously, people have to survive, so you must plan for unemployment, and you have to have a policy of supporting small businesses. You must also subsidize certain types of industry. But executing such a policy, in practice, is totally impossible for these governments. The ministries are staffed by people chosen for their political loyalty, not their competence. In addition, there are a few revolutionaries: great writers who spent many years in jail, economists who have the great honor of having studied at institutes of Marxist thought. Therefore, you basically have people with no experience in conducting government and no idea how companies may be affected by the constant changes in policies they propose. Thus, any plan of privatization in Eastern Europe that relies too much on the ability of the government to execute a complex policy to manage the transition ignores one of the most important variables in the transition—the absence of a genuinely competent government. Eastern Europeans understand that the government pollutes whatever it touches.

It certainly appears that privatization is an obstacle course that makes one extremely skeptical about whether something can be done fast. And, unfortunately, unless you do something fast the state sector very well may collapse, as it is collapsing in a number of countries. If the budget collapses, state services decrease and degenerate even further, which lures the government into the irresistible temptation of going back on the reforms. Also, if you wait too long, various interest groups will form. That is, if you do not privatize relatively quickly, these large industries may form insurmountable political blocks. The unions and the workers who do not want to lose their jobs are everyday becoming more hostile to the idea of privatization, and the managers will not increase their personal stakes in their businesses. Thus, the more the political system reflects the existing distribution of political forces, the more obvious the absence of interest groups that really support privatization and capitalism will be.

The move to privatization is basically inspired by an ideology, by people who believe that in the long-run it is in the best interest of the country to move into an economy governed by private property. But nearly nobody will gain in the short-run. There is no constituency for many of these reforms; on the contrary, every group has a special mindset, which is detrimental to long-term development. For this reason, I believe strongly that you have to combine the existing institutions in both the East and West with a lot of innovation, and basically try to accomplish the task of privatization by setting up a structure that will "privatize" the process of privatization. That is, economize on the need for government services and economize on the need for a highly trained government bureaucracy. One way of doing this is to encourage institutions to engage in the process of privatization as a business.

Second, you have to have certain foreign components, such as serious links to foreign capital markets and foreign expertise to assist in setting up the financial infrastructure of the capitalist system. Managers currently exist, and some of them can be competent if given the proper incentives, but no one knows what real banking is about, or what real securities are about, or even what real corporate government structure is about. Thus, the privatization program must bring in foreign institutions as participants for profit, but politics dictate that it must withhold full title to the property being privatized.

Sufficient numbers of Western investors cannot be brought in to buy East European industries because there is not enough confidence in the economy. Thus, Western participation must come in some other form, perhaps as managers of local investment funds. Those brought in to manage these funds must be brought in by the population at large or a segment of the population, but not by the government. Capitalism cannot be created by advisors; it must be created by entrepreneurs. And without entrepreneurs the privatization process will not succeed.

Finally, privatization programs must be sold to the population. The local people must have some stake in the program so they will have a special interest in supporting the reform. It is not enough to tell these people that they may starve but in twenty years their children will be fine. The communists have been telling them that for several years. It does not sell. Unless the population bonds with the process of transformation, it is going to fail. For example, regardless of what you tell the people in Czechoslovakia about mass privatization politics, they are still thinking, "What should I do with these coupons that the government gave me? Should I invest them with this fund or with that fund?" People have even begun to look askance at strikers because they have realized that strikes are really undermining their investments and economic growth. Therefore, unless you involve people in this game, even if it is only a game to some extent, the privatization process, that is, the game of capitalism, will fail.