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The Tunnel at the End of the Light: Privatization in Eastern Europe

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I. INTRODUCTION

In Eastern Europe, the collapse of Communism created an opportunity for the victims of one failed utopian ideology to find another. It did not take them very long.

The evaporating Soviet armies and their local apparatchiks left an ideological vacuum that was quickly filled by a remarkable outpouring of ideas on how to spread Western-style capitalism into the former Second World. Legions of Western advisers arrived in the wake of the departing Soviet troops to translate the goals of political democracy and a market economy into an action agenda. Democracy translated quickly into elections, a market economy into privatization.

As in many hurried translations, the bare essentials were grasped, but much was missed. Elections are essential to democracy, but functioning democracies are built on much more than just elections—even fair and honest ones. And private ownership, especially share ownership of large companies, is but one element of a modern market economy.

The exciting and relatively straightforward questions—how, and how quickly, to privatize state assets and to free trade—dominated discussion, both within Eastern Europe and in the growing ranks of Western advisers, consultants, commentators, and fortune seekers. Privatization, in particular, assumed special significance. The conventional wisdom was that Communist firms produced inappropriate, low quality goods at exorbitant costs because state ownership of industry distorted managerial and worker incentives. The generally poor performance of state industries throughout the Third World reinforced the impression that the state and the market do not mix. The main objective of Eastern European economic planners and their Western advisers became "getting the state out."

The fate of small enterprises like shops, restaurants, small landholding, or farms was never at issue. Everyone agreed that small-scale privatization should take place expeditiously. Putting small business in the hands of self-interested private citizens—"the natural owners"—seemed the best way to energize private sector growth, especially in service-related industries. Encouraging small-scale, private ownership also appeared likely to aid the growth of an entrepreneurial class and a capitalist ethic. It was Schumpeter, after all, who explained that it is the active small capitalist, the artisan, the proprietor, and not the renter or petty shareholder, who will go to the barricades to defend his property and the system that gives it value to him.[1] And in Eastern Europe, common sense dictated that the new system would need all the avid supporters it could get, and it would need them quickly. The early returns on these hypotheses have been promising. Spurred on by liberal small privatization laws and by the spontaneous opening of new

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1. JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY pt. I (3d ed. 1947).

enterprises, Eastern Europe, especially Poland and Hungary, has experienced a boom in small business activity.[2]

It was the fate of the huge and uncompetitive enterprises employing thousands of workers that posed the troubling dilemma.[3] Ideally, in the spirit of radical reform, these relics of a failed era should be condemned and closed. They would then be replaced by lean, competitive firms, not necessarily in the same product lines, but better aligned with each country's revealed comparative advantage. Social and political reality, however, made this choice quite impossible. What were the options?

Most experts considered only one alternative: privatization. The ensuing debates were limited to second-tier issues: Namely, how to transfer assets to the private sector? Which assets should be privatized? Who—foreigners, corporations, ex-Communists, ethnic groups, black marketeers, or former owners—should be allowed to obtain assets? How fast privatization should take place? But nobody ever questioned whether privatization should occur.[4]

Of those issues, the "how fast" question assumed pivotal importance. In many eyes, especially Western ones, delay presented the potential risk that the individuals or groups who stood to lose the most during privatization (i.e., old

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2. For an extensive discussion of new, small business activity, including 1991 data, in Hungary, the former Czechoslovakia, and Poland, see Simon Johnson, Private Business in Eastern Europe, Paper presented in Cambridge, Mass. at the National Bureau of Economic Research, Inc.'s Conference in Eastern Europe (Feb. 26-29, 1992). For a focus on entrepreneurial activity in the nations of the former Czechoslovakia, see Judith Brandsma, Entrepreneurial Development in Czechoslovakia, Paper presented at the OECD's Conference on Training for Entrepreneurship in Prague, Hungary (Oct. 10, 1991).

3. Hughes and Hare calculated that in 1991, taking into account the poor quality of Eastern European products, manufacturing in the former Czechoslovakia produced a negative value-added share of 34%, in Hungary 35.5%, and in Poland 38.9%. Sanjay Dhar, *Public Enterprise Restructuring: Achilles' Heel of the Reform Process*, TRANSITION, Mar. 1992, at 6, 6-8 (citing "Competitiveness and Industrial Restructuring in Czechoslovakia, Hungary, and Poland").

4. A cottage industry has grown up around privatization in Eastern Europe. The contours of the debate can be captured in the following selections: RONALD I. MCKINNON, THE ORDER OF ECONOMIC LIBERALIZATION: FINANCIAL CONTROL IN THE TRANSITION TO A MARKET ECONOMY (1991); JA'NOS KORNAI, THE ROAD TO A FREE ECONOMY (1990); Manuel Hinds, *Issues in the Introduction of Market Forces in Eastern European Socialist Economies*, WORLD BANK DISCUSSION PAPER, Apr. 1990 [hereinafter Hinds, *Market Forces*]; Manuel Hinds & Gerhard Pohl, Going to Market: Privatization in Central and Eastern Europe, Paper presented at the World Bank/*Treuhandanstalt* Seminar on Privatization in East Germany and Eastern Europe in Berlin, Germany (May 6-7, 1991); OLIVER BLANCHARD ET AL., REFORM IN EASTERN EUROPE (1991); David Ellerman et al., *Privatization Controversies East and West, in* 3 COMMUNIST ECONOMIES AND ECONOMIC TRANSFORMATION No. 3, at 283, 283-298 (1991); Horst Kern & Charles F. Sable, Between Pillar and Post: Reflections on the Treuhand's Uncertainty About What to Say Next, Presented at Conference on the *Treuhandanstalt* at Harvard University, Cambridge, Mass. (Nov. 1991); David Stark, *Privatization in Hungary: From Plan to Market or from Plan to Clan?*, 4 E. EUR. POL. AND SOCIETIES No. 3, at 351, 351-92 (1990); David Stark, *Path Dependence and Privatization Strategies in East Europe*, 6 E. EUR. POL. AND SOCIETIES No. 1, at 17, 17-51 (1992) [hereinafter Stark, *Path Dependence*].

For a discussion of reprivatization in Eastern Europe, see Andrew Schwartz & Laura D'Andrea Tyson, *Reprivatization in Eastern Europe: Roundtable Report, in* ANDREA BOHM & VLADIMIR KREACIC, REPRIVATIZATION IN CENTRAL AND EASTERN EUROPE: COUNTRY PRIVATIZATION REPORTS AND SPECIFIC IMPLEMENTATION ISSUES (1992).

line bureaucrats, and the managers and workers of state enterprises) would undermine the privatization process, thereby jeopardizing the transition to a market economy.[5] According to Jeffrey Sachs:

> [T]he need to accelerate privatization in Eastern Europe is the paramount economic policy issue facing the region. If there is no breakthrough in privatization in large enterprises in the near future the entire process could be stalled for political and social reasons for years to come, with dire consequences for the reforming economies of the region.[6]

The *Economist* agreed, calling "the growing acceptance of . . . gradualism . . . the greatest peril now facing the countries of Eastern Europe."[7]

As those favoring rapid privatization expected, a school of "gradualists" did emerge to advocate slower methods of privatization.[8] The gradualists contended that the short-run costs of rapid privatization would overwhelm any conceivable long-term benefit. Long accustomed to the protection of the state, the newly privatized companies would not be able to survive in a competitive market environment. The structures of both supply and demand for these large firms had been shattered; the industrial linkages between Eastern Europe and the former Soviet republics were severed. Politics suddenly separated firms from their customers just as the movement of rivers into new channels left medieval entrepôts high and dry on silted streams. Corporate failings resulting from sudden privatization would cause extensive layoffs, massive bankruptcies, and ultimately, social unrest. In a climate of chaos, the state would eventually have to support the failing enterprises in one way or another.

Structure alone dictated an active economic role for the state. A heritage of monopoly structures would mean a future of regulation. Who would regulate monopoly and oligopoly industries? Who would oversee the subsidization of the loser, and the reemployment of masses of workers? Who would oversee international trade and economize foreign exchange, functions that Western European governments found they had to do after World War II?

One could add to this prudent litany that private owners could not operate alone in an environment of open trade. The experience of East German industries,

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5. *See* Schwartz & Tyson, *supra* note 4.

6. Jeffrey Sachs, Accelerating Privatization in Eastern Europe: The Case of Poland, Paper presented at the World Bank Annual Conference on Development Economics (Apr. 25-26, 1991).

7. *Survey of Business in Eastern Europe*, ECONOMIST, Sept. 21, 1991, at 5.

8. The dichotomy between radical capitalists and gradualists oversimplifies the debate somewhat, though the thrust of the argument remains intact. For instance, Ost divides the gradualists into two factions. One, the Populist critique aims to minimize the social costs of privatization by warning that quick integration of Eastern Europe into the world economy increases the likelihood that the region will be pauper, not equal to the West. Two, the social democratic (usually consisting of ex-Communists) approach, emphasizes the importance of worker participation in transforming corporate ownership, noting the rise of post-Fordist techniques of production. David Ost, *The Crisis of Liberalism in Poland*, TELOS, Fall 1991, at 85, 93.

the best of the Eastern European bunch, provides a chilling example; they immediately and completely lost their home market to goods from West Germany. Sooner or later, and probably sooner, the government would have to limit or at least filter imports.

Finally, gradualists argued that the absence of credible capitalist or democratic institutions exacerbated the risks of rapid privatization. Essential preconditions for modern capitalist economies, such as an established legal system or tax code, financial institutions, and effective capital markets, did not yet exist. These shortcomings increased the odds that a "big bang in ownership" would turn into a "big bust."

Could the fragile democratic governments of the region cope with the fallout from widespread company closings? Probably not, argue the gradualists. Privatization's short-run risks would threaten a political backlash endangering not only the economic transformation process but also the future of democracy in the region. For their part, the advocates of rapid privatization, or "radical capitalists," generally concede the short-run risks, but contend that the long-run requisites for economic development—for example, private ownership—outweigh short-term expediencies.

Basic questions about the significance of private ownership underlie the debate between the gradualists and radical capitalists. Is private ownership of large enterprises, as its champions proclaim, essential for economic development? In the absence of credible market institutions, is private ownership likely to provide the necessary incentives for manufacturing innovation and efficiency to enable the former Communist countries to compete in world markets? Only by evaluating the impact of different ownership structures can one evaluate rapid privatization's short-run risks.

This article supports the gradualist position in Eastern Europe by questioning the tight linkage assumed between private ownership of big enterprises and economic growth both in general and within the region. The discussion incorporates four claims:

(1) Privatizing ownership will not, by itself, make large, uncompetitive firms operate efficiently and creatively. Private ownership makes sense only in the context of already established capitalist firms—firms that do not yet exist in Eastern Europe. The fundamental challenge for would-be Eastern European capitalists is the creation of competitive market firms from the state enterprises of the command economies, a process which will not occur quickly or painlessly. Large capitalist firms need expertise in pricing, accounting, legal matters, marketing, and advertising, in addition to the establishment of productivity incentives. In conjunction with the establishment of private, active ownership must come the creation of firms. Moreover, firms do not exist in an institutional vacuum. The character and eventual success of capitalist firms relies on domestic, and

sometimes, international, structures of law, finance, regulation, and industry. Private ownership, even in the Western context, can be meaningfully considered only in the context of embedded socioeconomic institutions.

(2) Eastern Europe is an unsuitable candidate for rapid privatization because of its minimal recent experience with capitalism and because critical linkages between firms, between suppliers and users, and between firms and their traditional markets, have been politically severed. Re-creating such international networks will take substantial time; these nations are too small to substitute domestic linkages for them. It will also take time to build complementary political and economic institutions, including the development of a "capitalist ethos." Erecting a system of domestic finance with efficient capital markets is but one important example of such needed institutions. Absent international industrial networks and those supporting socioeconomic institutions, large-scale privatizations will not produce viable private firms.

(3) The state will play the major role in industrial development in Eastern Europe and will remain the primary owner of large industrial assets regardless of the chosen privatization strategy. The vulnerability of state industry allows no other alternative. Nonetheless, the choice of a privatization strategy is significant in determining the precise role that the state will play.

(4) There are reasonable alternatives to simple private ownership of Eastern European large enterprises which should be explored. The creation of an honest and effective public administration—not the privatization of uncompetitive giant firms—is the key step toward the creation of a successful capitalistic market system and a functioning democracy in Eastern Europe.

II. OWNERSHIP AS IDEOLOGY— OWNERSHIP AS INSTITUTIONAL COMPLEXITY

Capitalism entered Eastern Europe to fill an ideological void. Mostly it was fundamentalist capitalism that poured in—the universal solution that all could understand: free prices, free trade, and privatization. It was simple and intense; a formula for action when fast and fundamental action was clearly needed. It quickly assumed the contours of the intellectually and emotionally empty space that it filled; it became an ideology. In the former Czechoslovakia, the observation that "'the leading role of the market' has simply been substituted wholesale for what was once 'the leading role of the party'"[9] captured the ideological role the new thinking assumed. Yet, like the ideology that preceded it, capitalism in its idealized form—with pure prices, free trade, and private owners—makes more sense as myth than as reality, myth in the Sorelian sense of the term: "A vague association of motivating images."[10]

In spreading their gospel of economic progress, radical capitalists oversimplify notions of private ownership, as well as pure trade and free trade, and pay insufficient attention to the integrated development of institutions in specific states and times; radical capitalists neglect history. Only "economic theory" enters the stage. This was, in part, due to the simple fact that most of these advisers are young and know little history, but are quite good with economic models. It is also due to the fact that any remotely appropriate historical experience, such as Europe after World Wars I and II, pointed in a quite different direction.

Radical capitalists insist that only a system of privately owned firms linked together by markets provides the right incentives and the right constraints, a set of signals that compel and restrain action that are all aligned towards social dynamism and allocative optimality. Moreover, market signals are prompt and unrelenting. Adaptation is fast and permanent. Planning systems are cumbersome and slow, adaptation is slow and uncertain.[11] For that reason, as well as the dynamics of selection under such a system,[12] private owners may be better managers than the state.

Private firms are also much more likely to be innovative and to increase efficiency given incentives derived from profit maximization rather than plan fulfillment; companies that do not produce quality products at competitive prices go out of business in market economies. Also, private owners have a stake in choosing the most efficient allocation of capital, whereas the state planner may have other motivations, such as maximizing employment or encouraging the development of an industrial sector that may be uncompetitive on world markets. One of the impressive aesthetics of capitalism is the perfect match between efficiency in capital formation and efficiency in production.[13] Moreover, newly privatized industries are likely to attract foreign investors—the main sources of modern technology and management skills—more readily than state counterparts. Finally, the competition induced from privatization might eventually result in the down-

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9. Stephen Engelberg, *East Bloc Treading Water in a Sinkhole of Lethargy*, N.Y. TIMES, Apr. 8, 1992, at A1, A16.

10. GEORGES SOREL, REFLECTIONS ON VIOLENCE (1912).

11. *See generally* SCHUMPETER, *supra* note 1.

12. *Id.*

13. For a transaction-cost analysis relating the structure of ownership with investment incentives in Eastern Europe, see Oliver Williamson, Private Ownership and the Capital Market, Paper presented at the Kiel Institute of World Economics' Conference on Privatization (Sept. 9-10, 1991). Supporting privatization, Williamson argues that "all assets, including capital, require an advocate, and private property is the only 'advocate for capital' that is both broadly-based and effective." *Id. See* Hinds, *Market Forces*, *supra* note 4.

sizing of large, uneconomic monopolies into more productively sized companies. At first glance, it is hard not to agree with the radical capitalists: private firms, even very big ones, are best, wherever and whenever.

There are two problems, however. First, simple-minded notions of private ownership structures obscure issues of control and incentives in modern capitalist economies. It is naive to reduce private ownership in modern industrial economies to a set of entrepreneurs with the authority and skills to manage large corporations. In practice, modern private ownership is a complex web of rights, obligations, warrants, leasing agreements, and shares. Actual control of a company depends not only on the distribution of ownership, but on the specific corporate structure. For instance, ownership in many large U.S. companies is divided among shareholders owning preferred and common stock. Others may own convertible bonds or warrants. Yet, the ability of one owner to influence corporate behavior will differ from that of another depending on the rights conferred by a particular security. For instance, in many cases preferred shareholders may not vote at shareholder meetings, while most common shareholders can. Both categories of shareholders are considered owners. Sometimes, even major shareholders of voting stock cannot influence corporate policy, as many U.S. investors discovered in the 1980s to their chagrin. At that time, some management teams opted to swallow excessive debt ("poison pills") to block takeover attempts that would have netted the shareholders big returns, but would have cost managers their jobs. At other times, owners of firms, especially those with large debt obligations, may share or perhaps cede control to financiers.[14] Evidence of corporate behavior derived from complex ownership structures already is appearing in Eastern Europe. In contemporary Hungary, David Stark reports that "some banks are beginning to act like owners—demanding dividends from the KFTs [limited liability companies] and RTs [joint stock companies] affiliated with state enterprises."[15]

Second, economic institutions influence the impact of ownership incentives.[16] Consider the horizon problem. Should a manager invest to stimulate the bottom line for the next quarter, or should the manager invest in research and development for the future? The answer depends on the institutional relationships among economic actors. In Germany, for instance, banks exercise ownership functions

14. The problem is that "[s]ince equity ownership in a public corporation is dissipated over a broad and ill-defined group of shareholders, the top managers together with their board of directors have 'power without property.'" Ellerman et al., *supra* note 4, at 283. They also observe that "there are remarkable similarities between the state and socially-owned firms of socialism and the public corporations of capitalism." *Id.*

15. *See* Stark, *supra* note 4. For a discussion of the increasingly complex nature of Hungarian ownership relations, especially the growing cross-holding among firms, private and state, see *id.* at 25-32 (section entitled "Institutional Cross-Ownership in Hungary").

16. A discussion of the horizon problem broken down by ownership type appears in Jan Winiecki, *Theoretical Arguments for Privatization*, 3 COMMUNIST ECONOMIES AND ECON. TRANSFORMATION No. 4, at 399, 399-414 (1991).

disproportionate to their actual equity holdings. Some analysts attribute the long-term horizon of German corporate planning to the oversight function of German banks that have an interest in encouraging the long-term stable economic growth of domestic firms. This also accounts for the efforts of German banks to block foreign companies from obtaining equity in major German companies.

For more than a generation after World War II, capital markets in France and Japan were not price driven; to an important extent, capital was allocated administratively, less by price (as in the proposed capital markets for Eastern Europe) than by a centralized system of priority allocative categories.[17]

In Japan, the most successful case of rapid development, ownership is of course "private," but only if one defines "private" merely as meaning not owned by the state. Interlocking shareholding and finance within *keiretsu* created something far removed from the simple ownership model of the radical capitalists. *Keiretsu* has no obvious analogy in the rest of the First World. Banks, trading companies, and the state bureaucracy have strong incentives to monitor management in the large Japanese companies. The long-term outlook characteristic of Japanese firms is widely attributed to structural interdependence of these different institutions. Who owns Mitsubishi? Perhaps the most accurate functional answer is "Mitsubishi owns Mitsubishi."

In the United States, on the other hand, owners of large chunks of corporate stock are typically financial intermediaries like mutual funds or pension funds.[18] Since transaction costs are minimal in U.S. markets and the availability of investment options abounds, it is easier for holders of financial assets to exit (by selling their interest) rather than exercise their voice (by trying to improve management).[19] This system encourages U.S. management to produce a good bottom line, and pay out high dividends to satisfy investors who are likely to have a short time horizon, rather than invest in research and development, which may prove more beneficial over the long haul.

Ownership structure is an important element in modern capitalism, but it is only one of many factors that influence corporate behavior and performance. The horizon problem highlights one of many aspects of those differences. Depending upon the institutional context, private ownership takes substantially different forms and functions. Ultimately, it has many different meanings. There is more than one variety of capitalism.

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17. *See* STEPHEN S. COHEN ET AL., CONGRESS OF THE UNITED STATES, CREDIT POLICY AND INDUSTRIAL POLICY IN FRANCE, MONETARY POLICY, SELECTIVE CREDIT POLICY, AND INDUSTRIAL POLICY IN FRANCE, BRITAIN, WEST GERMANY, AND SWEDEN; A STAFF STUDY PREPARED FOR THE USE OF THE JOINT ECONOMIC COMMITTEE, CONGRESS OF THE UNITED STATES, U.S. GPO NO. 77-744 O (1981). *See also* JOHN ZYSMAN, GOVERNMENTS, MARKETS, AND GROWTH (1983).

18. Mutual funds or pension funds in the American context are very different animals from those mutual funds envisioned in Eastern Europe, or in particular, in Poland.

19. *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970).

III. STRUCTURAL CONSTRAINTS: THE EASTERN EUROPEAN CASE

Just as it is dangerous to apply narrowly naive concepts of capitalist institutions to Eastern Europe, so it is dangerous to generalize about this region and apply a single set of institutions and a single strategy across the different countries. Even a passing acquaintance with Eastern Europe reveals countries with different political systems, legal traditions, ownership patterns, educational levels, industrial structures, languages, ethnic cleavages, religions, and population sizes. Little wonder that of the four Eastern European countries most actively engaged in privatization—the former Czechoslovakia, Poland, Hungary, and Slovenia[20]—each had a different privatization strategy. Nonetheless, the demise of Communism left a legacy common to each state: to wit, experience with the plan and inefficient centralized state enterprises inexperienced with capitalist institutions.[21] This legacy constrains the prospects for rapid privatization in the region.

There are at least eight interrelated sets of common problems certain to complicate both privatization and the construction of effective institutions throughout Eastern Europe.[22] These problems are discussed in detail below.

A. *Shortage of Entrepreneurial Experience*

More than four decades of Communist rule in Eastern Europe have produced a managerial class unequipped to produce for a capitalist market, not to speak of the entrepreneurial effort implied by the complex restructuring necessary for dynamic growth. Most of the market experience in the region comes from the "Second Economy," and journalistic accounts of black market ingenuity aside, it is dubious that such experience will translate into competent large company owners or factory managers. Besides the petty black marketeers, the other likely new ownership strata is going to be either those who made money illegally or corrupt bureaucrats, or most likely both, working together as they always have.[23] They would be the ones to split up existing enterprises into their valuable and

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20. East Germany could be added to this list, but its incorporation into the German state distinguishes it from the other cases.

21. For instance, Poland plans a mass privatization scheme open to all citizens, entitling them to ownership of shares of mutual funds. *See* Country privatization papers presented at the Second CEEPN Annual Conference on Privatization in Central and Eastern Europe in Vienna, Austria (Nov. 29-30, 1991). The former Czechoslovakia has embarked on a voucher scheme which entitles nationals to purchase vouchers in individual firms or mutual funds. *Id.* Hungary is using a mix of programs, most recently emphasizing the sale of enterprises to financially sound investors based on review by private consultants. *Id.* Slovenia is intending to sell off its industries to the highest bidder. *Id.*

22. This is, of course, only a partial listing. A more comprehensive roster of problems includes macroeconomic stabilization, the lack of administrative capability, ambiguous prior ownership structures, and environmental problems.

23. ARKADY VAKSBERG, LA MAFIA RUSSE [THE SOVIET MAFIA] (1991) (translated from Russian).

potentially negative parts, shift excess labor across those parts, maintain their control of the good portions, and benefit from a substantial capital gain at the moment of privatization; millionaires, in one quick shot, no matter how well or badly the enterprise would then perform. Furthermore, where assets would be auctioned off to the highest bidder, only these networks of officials and plant managers, with their underground allies, most often called "the Mafia," would have the cash to bid. This potential was not lost on some of the more sophisticated foreign advisers: Bars in foreigners-only hotels were filled with IMF and World Bank officials explaining how the late medieval capitalists in Europe were considered, in their time, to be criminal elements. And look at the winners of the U.S. bootlegging wars; they have now become solid, corporate capitalists. The belief was that as it invariably did in the United States, privatization and legalization would eventually transform the Eastern European criminal mafias into legitimate organizations—unless, of course, the southern Italian model reasserted itself.

B. Shortage of Companies Ready for a Market Economy

Many enterprises are burdened with obsolete technology and a poorly trained workforce.[24] Other enterprises are encumbered by staggering amounts of debt. Much of the borrowing resulted from irresponsible management of state finances rather than company mismanagement. State enterprises were a convenient receptacle to stash government debt.[25] Recognizing the nonviability of many large enterprises, Hungary, Czechoslovakia, and Poland decided to implement privatization slowly.[26] Even the *Treuhandanstalt (Treuhand)*, the holding institution set up by the German government to sell off and restructure assets in eastern Germany, has privatized only about half of the eastern German industries, despite a DM 100 billion infusion of capital from western Germany;[27] about 1.6 million workers remain employed under *Treuhand* jurisdiction.[28] Despite its ferocious determination to the contrary, it would not be surprising if the *Treuhand* found itself slowly transformed into a new German version of Italy's much

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24. The problem may not be the quality of training, but the type of training. The specific skills of an Eastern worker must correspond with Western production methods. One manifestation of this problem is the difficulty that very highly trained East Bloc mathematicians are having in getting jobs in the U.S. computer industry. These specialists are highly experienced, yet not familiar with Western operating systems. As a result, it is hard for them to get jobs; they need to be retrained—an expensive and time-consuming process for a prospective employer.

25. *See* Jan Vanous, Near-Term Prospects for Economic Reform in Eastern Europe, Paper presented at the World Bank Annual Conference on Development Economics (Apr. 25-26, 1991).

26. Johnson, *supra* note 2, table 12.

27. Rudiger Dornbusch & Holger C. Wolff, Eastern German Reconstruction, Paper presented at the Conference on Transition in Eastern Europe in Cambridge, Mass. (Feb. 26-29, 1992).

28. Figures are as of December 31, 1991. FACT SHEET (*Treuhandanstalt*, N.Y.), Jan. 7, 1992. Nearly 5000 out of 10,500 businesses have been sold. *Id.*

maligned *Istituto per la Ricostruzione Industriale* (IRI, the giant state holding company).

C. Shortage of Domestic Capital

The previous regimes left the economies virtually without savings.[29] The rebuilding of the industrial capacity in the region will have to rely on only small contributions from the accumulated savings of the domestic population. Newly privatized firms will need to rely on debt financing from domestic banks or from institutions based abroad. However, no Eastern European government has an established banking system ready to make the necessary loan commitments. Moreover, real and nominal rates are high and credit is generally very tight throughout the region. Loans are very difficult to obtain.[30] The major source of capital is likely to remain the state, or in very select circumstances, foreigners.

The newly privatized firms, striving to become competitive, will not be the only large claimant on the small capital pool. Indeed, they will most likely find themselves on the tail end of the queue. The appalling inadequacy of basic infrastructure will force the state and the foreign donors to funnel scarce capital first to road building, basic telecommunications (e.g., telephone installation), airlines, railways, and the like, not to mention the special problems posed by electric power generation—the handling of those dangerous, badly built nuclear power plants on Europe's doorstep. These sectors, the kind typically operated as regulated monopolies in the United States, are very likely to absorb the lion's share of foreign aid and investment.

Electric generation is particularly pressing. The Western Europeans want those power stations rebuilt for greater safety, and the European nuclear power industry is hurting terribly from a dismal lack of new orders. This creates a nice opportunity to combine safety in the West with the spread of capitalism to the East and generate business for state supported firms in the West. Electric power generation industries will surely receive massive foreign investments, especially if they are privatized, with which they can purchase equipment and services from the West.

Modernizing infrastructure is expensive. To get an idea of the potential costs, consider German investment in the former East Germany. Germany invested $14 billion in new telecommunications systems and an additional $22 billion in road construction and other transportation networks in the provinces of former East

29. There is also a problem with foreign debt, though amounts differ: as of January 1991, Poland, $11 billion; Czechoslovakia, $6.7 billion; Hungary, $19.5 billion; and Yugoslavia (including Slovenia and Croatia), $7.5 billion. COOPERS & LYBRANDT, DOING BUSINESS IN EASTERN EUROPE AND THE SOVIET UNION 80-81 (1991).

30. *See* Johnson, *supra* note 2.

Germany.[31] In addition to these expenditures, Eastern European governments are sure to be financially burdened from "meeting the interest and principal payments on the foreign debt, funding the social safety net and retraining programs for the workers becoming unemployed as a result of the restructuring of the economy, financing the pensions and health care needs of the ageing population, modernizing the educational system . . . [and] paying for the needed environmental cleanups and safeguards."[32]

The classic infrastructural industries are also the best candidates for privatization. They could produce tradable shares to generate capital markets. They would also be acceptable vehicles for international aid and investment, especially European Bank for Reconstruction Development (EBRD) assistance, tied as they are to a substantial portion of private sector lending.[33] Infrastructural industries are the easiest to manage; they do not have to compete. They can be made to generate correct returns. All in all, they present an ideal set of privatizable activities completely protected from the vicissitudes of markets and competition. Infrastructural industries will remain regulated and thereby generate few of the capitalist virtues that exemplify the purpose of privatization.

Finally, those who expect a major capital injection from the West are likely to be disappointed.[34] For one thing, the recession and the high government deficits run by Western governments have drained the coffers of prospective donors. For another, there are many alternative investment opportunities for scarce Western capital in eastern Asia, Latin America, and even in eastern Germany and the former Soviet Union.

The amount of foreign investment flowing into the region has been disappointing. For example, in 1990 and 1991, Poland received $1.3 billion; Czechoslovakia, $0.8 billion; and Hungary, $2.3 billion.[35] Over the same period, former East Germany received over DM 100 billion in total transfers from western Germany. Western governments have not been overly forthcoming either. For instance, total World Bank commitments to the region for 1991 only amounted to a little over $3 billion.[36] The EBRD devoted only about $800 million, of which $377 million was for telecommunications loans.[37] Prospects

31. *See* FACT SHEET, *supra* note 28 (presenting *Treuhandanstalt* data).

32. Ellerman et al., *supra* note 4, at 287.

33. According to Rolf B. Westling, EBRD's senior country manager, "[A]s to our policy of privatization, EBRD conveyed a message to the governments in the region, confirming that it would like to be associated with the process, particularly with the privatization of various utilities, transport companies, power generation plants, telephone companies, and the like." *EBRD: Cooperation Instead of Rivalry with World Bank: An Interview with EBRD's Rolf B. Westling*, TRANSITION, Apr. 1992, at 7.

34. Jan Vanous is among those who emphasize the importance of a large capital influx into the region. Jan Vanous, *Nuts and Bolts of Economic Reform in Central and Eastern Europe*, TRANSITION, June 1991.

35. Stephen Engelberg, *Eastern Europe Foils All but the Hardiest of Western Investors*, N.Y. TIMES, Mar. 5, 1992, at A1, A1, D8.

36. TRANSITION, June 1991, at 3.

37. TRANSITION, Apr. 1992, at 6.

for future foreign investment in the area remain guarded, though the share contributed by international organizations is slated to increase.

D. Business Conditions Are Very Risky

Marko Simonetti, director of privatization for Slovenia, argues that the challenge of privatization is to find active owners willing to lead companies through the transition period.[38] But this is easier said than done. After all, why should new owners restructure their enterprises when there may be an immediate payoff if they liquidate the assets? In most cases they should not, especially if foreign competition is allowed. Domestic producers will not be able to compete effectively in world markets, especially against the East Asian Newly Industrialized Countries (NIC). A brief taste of what lies ahead is the case of large state enterprises in eastern Germany; unable to compete abroad, these firms lost their home market when companies from the western part of the country moved in.[39]

The temptation to liquidate rather than to invest is heightened by the asset value of many companies. The company's land, buildings, and the right to do business may be worth more in the marketplace than its productive potential, which lies in often dubious and difficult assets like machinery or the labor force. A common story is that of CKD Tatra—until recently, the world's largest maker of tram cars, but today a manufacturer of only 300—which has attracted investment interest partly because the site of its old factory "occupies acres of prime real estate, a hop, skip, and two subway stops from . . . Wenceslaus Square."[40] Prospective investors in this firm would have little incentive to restructure this outmoded tram works when they could easily profit by closing the factory and selling or developing the land.

The state needs to be very careful in establishing market rules and regulations that encourage productive investment and discourage passive holdings.[41] There is a fine line between an entrepreneur who is innovative and one who is rent-seeking. Consider the role of incentives in the experience of successful Slovene exporters in the mid-1980s. These firms were the largest earners of hard foreign currency in the area because their products sold well abroad. Ordinarily, one might expect that the exporters would reinvest the profits in expanding its core

38. *See* Marko Simonetti, Review of Jeffrey D. Sachs' *Accelerating Privatization in Eastern Europe: The Case of Poland*, Presented at the World Bank Annual Conference on Development Economics (Apr. 25-26, 1991).

39. Stark, *Path Dependence*, *supra* note 4.

40. Peter Passell, *Czech Streetcars None Desire*, N.Y. TIMES, Mar. 18, 1992, at C2.

41. According to Dr. Manfred Balz, General Counsel to the *Treuhandanstalt*, "The *Treuhandanstalt* has been quite ingenious in inventing a variety of clauses against disinvestment," including securing promises from investors to guarantee minimum future investments and minimum employment levels, and incorporating resale clauses in the original sale agreements. Dr. Manfred Balz, Approval of Privatization Decisions: The Case of Germany, Paper presented at the Second CEEPN Annual Conference in Vienna, Austria (Nov. 30, 1991).

businesses, perhaps with aggressive marketing or by upgrading quality. Yet, as of 1991, the Yugoslav dinar was greatly overvalued. So, like any resourceful Western tourist who happens to be carrying hard currency into a country where the home currency is overvalued, the Slovene exporters exchanged the hard currency earnings with black marketeers. In fact, the trading was so successful that the exporters decided to go into the currency trading business themselves, plowing their foreign exchange earnings into trading rather than reinvesting in the productive export business.[42] The result: a classic horizon problem. Hungary proposed to discourage rent-seeking by restricting speculation on farmland acquired through reprivatization.[43]

E. Lack of Historical Cooperative Links Between Labor, Suppliers, Manufacturers, and Consumers

First World countries like Japan and Germany were able to get back on their feet quickly after World War II partly because reconstruction meant the reconstitution of forms of economic organization established years earlier, rather than the creation of completely new relationships. For instance, *keiretsu*, the centralized forms of ownership in Japan, were antedated by *zaibatsu* which originated in the Meiji era.[44] German business and unions reached durable working arrangements long before the postwar German miracle. The antecedent for the workers councils, a keystone of modern German corporatism, was established during World War I when military imperatives prompted governmental accommodation with labor.[45] Throughout Scandinavia and Western Europe, institutional networks among business, labor, and government that facilitate domestic peace and economic growth evolved over a 100-year period.[46] These relationships will not occur overnight in Eastern Europe.

F. Poor Work Habits

One element of the Leninist legacy is evidently a workforce that does not want to work. This report from the *New York Times* is commonplace: "Managers of new private companies say they must dismiss dozens of people to find one not afflicted by the lackadaisical work ethic fostered by the Communist system. Private hotels in Warsaw do not even accept applications from former state

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42. Discussion with Tea Petrin, Professor of Economics, Faculty of Economics, University of Ljubljana, Slovenia.

43. *See* Schwartz & Tyson, *supra* note 4, at 27-29.

44. Akira Uegaki, Address at the University of California, Berkeley (Mar. 11, 1992).

45. KATHY THELEN, UNION OF PARTS: LABOR POLITICS IN POST-WAR GERMANY (1991); HANS-JOACHIM BRAUER, THE GERMAN ECONOMY IN THE TWENTIETH CENTURY 27 (1990).

46. *See* PETER KATZENSTEIN, SMALL STATES IN WORLD MARKETS: INDUSTRIAL POLICY IN EUROPE (1985).

employees."[47] Another element is the hierarchical mentality that still pervades Eastern European enterprises. In the past, the incentive structures in Communist enterprises discouraged managers from acting with initiative. In most cases, managers, especially middle-level managers, were better off merely to play along with the system rather than risk their position by exercising discretion.[48] This is hardly a prescription for entrepreneurial dynamism.

G. Ethnic Divisions

Many countries in Eastern Europe are fractured by ethnic cleavages, language differences, and religions. In many cases these differences have not been politically or economically resolved.[49] Divisions between Czechs and Slovaks, Croats and Serbs, and Hungarians and Romanians are likely to complicate effective economic policy making. The situation in the former Czechoslovakia illustrates the difficulties brought about by ethnic haggling. Populist separatist movements in Slovakia are clashing with reform-minded Czechs like Klaus, which has the potential of paralyzing economic reform.[50] Perhaps an even more poignant example is the former Yugoslovia, where civil war has relegated economic reform to the back burner.

H. Small National Markets and Broken International Linkages

The long-run economic choices of Eastern European countries will be restricted by the small size of national markets in the region. The countries are mostly both small and poor. To achieve competitive viability, industries in small countries must be active participants in foreign markets. By the same token, it is much cheaper for these exporting firms and domestic consumers to obtain imports on the international market, rather than have these same goods produced inefficiently at home.[51] Ideally, industries in small countries operate in a very open international market; source where value is best and sell internationally in niches. They must be outward looking and very dynamic—exactly the opposite of Eastern European large enterprises.

To approach this norm in the Eastern European case, industrial restructuring will be necessary on a massive scale. But such restructuring means the closing of

47. Engelberg, *supra* note 9, at A1.

48. Arum Swamy told the authors that he observed the same complaints of bureaucratic behavior, etc. in large Western firms.

49. Ethnic differences need not be fatal for economic compromise. Note, for instance, the impressive economic growth in Belgium where Flemings and Walloons sometimes tangle. There are also important ethnic cleavages in Switzerland and Netherlands, two countries with among the best economic performance records in the world.

50. Peter Passell, *An Economic Wedge Divides Czechoslovakia*, N.Y. TIMES, Apr. 19, 1992, at 4E.

51. For a discussion of the challenges of small states, see KATZENSTEIN, *supra* note 46.

many, probably most, large enterprises and the loss of several thousand jobs. Isolated from the world market, large firms in Eastern European countries produced goods made better and cheaper abroad. They operated in captive markets and they exported on a large scale to similarly noncompetitive foreign markets within the realm of the planned economies. They learned to operate with constant output and input prices and virtually unlimited access to credit. Sooner or later many of those companies must be eliminated as national resources are channeled into products where the Eastern European countries are likely to have a competitive advantage, not just compared to one another, but compared to the entire world. As one big firm in the region tries to improve itself by sourcing quality components from the world market, it dries up the markets for the other large firms, its traditional suppliers. When local consumers get a little real money and the choice to buy coveted imported goods rather than generally lower quality local products, the entire system collapses.

The industrial structures of Eastern Europe were created with important linkages to the regions of the former Soviet Union. These networks of customers and suppliers are now completely severed. As a result, Eastern European companies have lost the only conceivable buyers for what they produce and the cheap suppliers of what they need in order to produce. The problem is not simply one of efficiency as revealed in price; it is one of political borders and disruption. Even a substantial increase in efficiency will not make up for the tattered regional industrial structure. It takes years to build a new structure, and a new structure cannot be built until the political uncertainty is overcome. Private investment—obtained in a real capital market—will not be easily forthcoming in newly privatized companies that are unsure of where their markets lie, where their sources of supply are located, or who their competitors are. Additionally, the new international industrial structure of Eastern Europe will not be built quickly. For the future of capitalism in the region it is the most important construction. The desired gains in efficiency will not be realized, and even if somehow they could be realized, they will not compensate for the loss of established interindustry linkages, economies of scale and economies of certainty.

The situation is something akin to what happened after the *Treaty of Versailles* redrew the map of eastern Europe at the end of World War I. Borders and impenetrable political and economic obstacles separated firms from their traditional customers and suppliers. Activity came to a halt and thousands of people were thrown out of work. After World War I, it took over ten years for eastern Europe to return to 1913 levels of industrial production.[52]

These eight obstacles would deter the most ardent reformers from attempting a program of drastic and potentially all-or-nothing industrial change. But they will

52. DEREK ALDCROFT, FROM VERSAILLES TO WALL STREET, 1919-1929 ch. 5 (1987); LEAGUE OF NATIONS, INDUSTRIALIZATION AND FOREIGN TRADE 134-37 (1945).

not deter the radical capitalists. In their view, the private ownership of large enterprises will put the Eastern European economies on a solid footing—in time. According to the radical capitalists, it is precisely because of the problems confronting the region that it is essential to install private ownership quickly.

The radical capitalists' prescription for Eastern Europe might be tenable given a stable institutional setting with a functioning tax code, established financial system, legal system, broad-based capital markets, and credible political guarantees, as well as plausibly operating networks of international markets and industrial linkages. However, there are few credible, tested institutions. Without them, rapid privatization will not provide a solid base for prosperity, nor will it aid the growth of an active independent entrepreneurial class.

The next section considers the likely consequences of rapid privatization in the absence of just one institution: viable financial broad-based capital markets. We select capital markets because, evidently, it is the institution most dear to the radical capitalists, and it plays an important symbolic role in the popular imagination. But any of the others would do just as well; indeed, capital markets are probably easier to create than, for example, the honest and extremely competent public regulatory bodies that will be necessary for rapid privatization to succeed, or even for capital markets to function positively.

IV. The Importance of Institutions: The Crucial Role of Capital Markets

Capital markets remove power, in giant dollops, from the hands of entrenched bureaucracies. They are fast and powerful. They move mountains and provide invisibility for the movers: It is difficult for a public bureaucracy to close down the only industry in a midwestern U.S. town, that now-familiar objective is more easily achieved by a twitch on the Tokyo or New York stock exchanges. Capital markets are also a major entertainment industry in their own right, something of a cross between the tables of sporting results that fill so many pages of newsprint and minutes of air time daily, and Hollywood gossip stories that fill much of the rest of most information media. In these, and many other ways, broad-based capital markets are wonderful creations.

In capitalist economies, broad-based equity markets serve both investors and corporations alike in two general ways. First, equity markets signal the underlying value of securities. Theoretically, this facilitates the proper allocation of resources by providing both investors and companies opportunities to raise cash as well as to spread resources among businesses that vary by product line and investment risk. Accurate share valuations also provide stockholders with a de facto evaluation of management, which may sometimes precipitate corrective action. Second, equity markets provide venues for companies to raise capital (equity or debt) over a wide net of investors. By the same token, equity markets enable investors to control more easily risk in their portfolio. Finally, equity markets ease the costs of investment and corporate restructuring by providing liquidity to both investors and corporations alike.[53]

But price-driven, broad-based, open capital markets are not a sine qua non for successful "capitalist" development. As noted above, two of the most successful of the capitalist nations, France and Japan, relied on financial systems that did not allocate capital in an open market simply or essentially by price during almost two generations of rapid postwar growth and modernization. Both successfully used centralized systems of priority allocation.[54] Korea is a more recent example of spectacular capitalist development with something other than a price-driven, broad-based, open capital market.

Because they are so powerful, capital markets are dangerous, especially when they lack proper safeguards and depth. In Eastern Europe, the hazards are particularly acute because of the complete lack of experience in using these markets. Additionally, capital markets are likely to attract more attention than usual because of their novelty in the region and their significance as a capitalist symbol. To simplify matters, the following discussion concentrates on one type of financial capital market: broad-based equity or stock markets.

Radical capitalists assume, correctly in the authors' view, that capital markets will arise concurrently with privatization and the issuance of shares. The process is already underway. Despite few viable companies, public stock markets are being organized throughout Eastern Europe.[55]

Unfortunately, in spite of the best of intentions, Eastern European equity markets probably will not be able to perform efficiently and may perform with delegitimating perversity.[56] It will be virtually impossible to establish fair market value for the exchange's listed companies given the shortage of capital in the region and the unstable business conditions. The lack of well-established, highly capitalized market participants forebodes a lack of liquidity in the equity markets. This will produce equity markets with thin market conditions and wild price swings, since insufficient numbers of large investors will exist to support prices. The inexperience of the domestic traders may also increase the likelihood of intermittent price plunges. Investors are likely to see the values of their portfolios fluctuate wildly. Many will lose their investment, and with it faith in the market.

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53. Williamson considers the reverse question: "Can capital operate given state ownership?" *See* Williamson, *supra* note 13, at 1. His answer is "no." *Id.* "Lacking an effective advocate, capital is predictably misallocated, dissipated, and/or expropriated." *Id.*

54. *See* COHEN ET AL., *supra* note 17.

55. Commodity markets are starting to spring up, in some cases with help from U.S. exchanges. For example, according to Randy Warziger, Director of Marketing of the New York Mercantile Exchange, the New York Mercantile Exchange and Chicago Board of Trade are training Russian and Hungarian traders and regulators.

56. A neglected issue is what the new shareholders of Eastern Europe will do with their shares. In the United Kingdom, most recipients of discounted shares from the privatizations resold the shares and spent the found money. Commentators observe that the U.K. experience would probably recur in Eastern Europe given the levels of pent-up consumption demand. Ellerman et al., *supra* note 4, at 287.

Rather than resemble the efficient, "thick" markets of the West, like the New York Stock Exchange, Eastern European equity markets are likely to have more in common with the freewheeling stock markets of the Third World.[57]

Corruption is sure to become a big problem. Inexperienced Eastern European market regulators will not be able to police markets that are moving quickly, and without apparent reason. Market rigging and stock manipulation are inevitable. Even in the most sophisticated trading environments, flagrant abuses are commonplace. The charges run the gamut from stock manipulation and inside information to kickbacks and money laundering with organized crime. For instance, in Japan, ". . . the former top executives of Nomura Securities and Nikko Securities—the largest and third largest brokerage houses in Japan—testified before Parliament that their firms had for years done business with an organized-crime figure, helping finance what may have been a huge stock manipulation scheme." In the United States, the popularity of junk bonds and the dishonesty of unscrupulous salesmen like Michael Milken and Charles Keating helped produce the savings and loan debacle and the fall of Drexel, Burnham & Lambert, a large investment house. Even the U.S. treasury auction proved vulnerable to corruption. In a U.S. Treasury publication in 1991, Salomon Brothers admitted to cornering the market. As the most experienced traders will attest, market operations are very complex, and enforcing fair rules can be nearly impossible.

How will inexperienced Eastern European regulators be able to protect investors and enforce the market rules when information is scarce and maldistributed, markets are thin, prices are fluctuating wildly, and markets are dominated by only a few players? The answer: They won't be able to. Investors are sure to think they are being cheated, and most often they will be right. This potential for delegitimizing the entire effort to create a functioning market system, even more than any perverse effects the wild new capital markets may have on the optimality of capital allocation, is the primary danger. The first rounds of stock market activity are sure to see managers and their invisible partners in the administration cash in big. A crop of instant millionaires, whom everyone knew as the old *nomenklatura*, will become conspicuous symbols to be manipulated by potential demagogues. Eastern Europe may soon have truly "Far West" financial markets, but Eastern Europe is not the Far West; it lacks the vast safety valves and alternative opportunities of that place and time.

57. Third World stock markets are characterized by extraordinary booms and busts. In Mexico, in 1986, the Mexican stock market (with only $820 million in share capital spread over the top 10 firms) rose over 600% before crashing in 1987. In Turkey (where new share offerings barely exceeded $10 million) over 1986 to 1987, the stock market rose over 1000%, only to drop precipitously later on. Volatile stock markets are also part of economic life in Nigeria, Egypt, Brazil, Thailand, and throughout the Third World. *See generally* INT'L FIN. CORP., EMERGING STOCK MARKETS FACTBOOK (1989). Figures are in U.S. dollars, estimated from stock market indexes. *See id. See also* Henry Brenen & John Waterbury, *The Political Economy of Privatization in Developing Countries*, WORLD DEV., May 1989, at 620.

If the resentment against black marketeers in Eastern Europe is any indication, there will be a groundswell against the "excessive" greed and corruption in the equity markets.[58] Legitimate operators could get caught up in the popular outrage, so might the whole reform movement, especially in the context of large-scale economic misery and uncertainty experienced by what some tend to refer to as "honest, hard working native people." The reaction is likely to be exacerbated as domestic restructuring gathers steam and many workers lose their jobs. Eastern Europeans may soon give literal meaning to the attitude of Yoshihiko Miyauchi, president of Japan-based Orix Corporation: "Too many Japanese made money without sweating in the 1980s, which I personally think is unethical . . . . I think we have to kill this sentiment."[59]

Until a viable equity market is operational, companies are likely to go elsewhere to raise capital or sell assets—they will privately place equity or raise capital through debt rather than equity.[60] In the West, market valuations can be arrived at fairly quickly due to the relatively free flow of information and the efficiency of markets. In the East, however, market valuations will be much more problematic. This problem will be exacerbated by the lack of accepted accounting standards and a credible tax system. These added uncertainties will make it much tougher to raise capital. Under these conditions, Eastern European firms will have no choice but to rely on the state, or in special cases private banks or foreigners, for their capital requirements. The investment policy of the newly privatized enterprise is likely to become dependent on the state. Independent active ownership may become an illusion, even given a plan of rapid privatization.

V. Public Enterprises Reconsidered

Radical capitalists insist that state ownership and capitalism do not mix, nor do state ownership and rapid development. In their view, the Communist economic malaise is just another failure of state ownership. Throughout the world, they argue, state-owned industries are notoriously inefficient and corrupt. In the Third World, where the state is a major asset holder, the record of state-owned industries is particularly appalling. There is little wonder that many poor nations,

58. Foreigners, who may play the pivotal role in the home stock markets, are likely targets for popular resentment. In 1991, the Budapest stock exchange suffered a 25% decline as foreign investors, the primary investors, became concerned about growing political uncertainty. TRANSITION, Feb. 2, 1992, at 10.

59. James Sterngold, *Japan's Rigged Casino*, N.Y. TIMES MAG., Apr. 26, 1992, at 27, 27-28.

60. One situation in which companies looking to raise capital may use the equity markets is the case of a rapidly rising, speculation-driven capital market. In this circumstance, companies may choose to float stock as share-starved investors pay inflated prices for corporate equity. Such a dynamic is underway in India, where many companies are currently using the stock market as a source for capital. The potential for investor bankruptcies arises, however, if companies are unable to show profits justifying a high stock price and the stock bubble bursts leaving investors holding the bag.

as diverse as India, Bangladesh, Turkey, and Mexico, have embarked on massive privatization programs in recent years.[61]

However, state ownership makes sense at certain times such as when markets are imperfect. In Eastern Europe, as in the Third World, there are few private alternatives. Entrepreneurial experience, sufficient capital, developed markets, and modern infrastructure are typically in short supply.[62] Under these conditions, sustained private investment is very difficult to obtain, especially from foreigners. Capital shortages are already evident in Eastern Europe. Eastern European medium-sized firms are finding it tough to get fresh foreign capital because of the so-called "play-safe attitude of Western banks." This means that industries which may hold long-term economic potential or whose development may be in the national interest will never get off the ground. The state must step into the breach. Finally, and most prominently, there is the repeated history in country after country where a sudden implosion of whole sectors results in the state being forced to step in and nationalize the losers. Hence the typical state sector arises, with its portfolio of coal mines, steel mills, railways, and shipbuilding docks. Italy and Spain have lavish government portfolios so acquired. This history of nationalizing dying industries in response to political pressures, or more simply of managing the difficult task of restructuring and downsizing as painlessly as possible, has given state-owned enterprises their bad name. They are, most often, collections of basket cases that no one else would take. This makes their experience particularly relevant to Eastern European big business.

There are, however, examples of state-owned companies, nationalized for one reason or another, that were not already dying. France provides the best examples. Here, the history of the companies' performance has been anything but negative. As late as thirty years after World War II, the French state still owned all major firms in steel; coal; oil distribution and refining; transportation and exploration; automobiles, trucks, and buses; rockets; cigarettes; electronics; ocean shipping; aircraft and airlines; skyscraper office development; radar; radio and television broadcasting; telephone equipment and services; gas and electricity; and in addition, horrid as it may seem, most big banks and insurance companies. And this is but a partial list. The postwar modernization, restructuring, and growth of the French economy has been extraordinarily successful. In addition, state-owned firms played a leading role, not simply a shock-absorbing role, in that transformation and modernization.[63]

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61. India is more accurately a case of limited privatization. The government is divesting only some portion of company shares while retaining control primarily through state-owned financial institutions and mutual funds.

62. PUBLIC ENTERPRISES AND DEVELOPMENT IN ARAB COUNTRIES 1 (1978) (stating that in rare cases, a surplus of available revenues may actually encourage state intervention—for example, the experience of oil producing Arab states). *See* V.V. RAMANADHAM, THE ECONOMICS OF PUBLIC ENTERPRISE 25 (1991).

63. For a discussion of the role that the state and state firms play in French industrial modernization, see STEPHEN S. COHEN, MODERN CAPITALIST PLANNING: THE FRENCH MODEL (1969).

In Japan and Korea, the giant industrial groupings that dominate the economy defy simple classification as either private or public. Nor is there any compelling reason to make the distinction. Surely the great Japanese *keiretsu* are not public firms; the government does not own them. But it is extremely difficult to assimilate the Sumitomo or Mitsubishi groups into the traditional category of private firms. The market is not the opposite of the government; the firm is not in opposition to the State. There are many varieties of institutional arrangements, and they change with time and circumstance. The all-or-nothing, public bureaucracy, or private (capital-market based) firm model is dangerously simplistic. It pops out of textbook economics, not out of the history of successful economic development, especially "catch-up" development. And that, after all, is the relevant genre for Eastern Europe. The peoples of Eastern Europe do not have to invent their future, just catch up with it.

What determines the success of state-owned enterprises? It is not just ownership. State-operated industries can be operated efficiently or inefficiently, using technologically advanced production techniques or backward ones. Empirically, the answer is clear. Good performance is a function of the domestic political economy, not just the fact of state ownership.[64] Christianson[65] and Vernon-Wortzel and Wortzel observed[66] that privatization without liberalization produced few gains. In a survey of state enterprises in Asia, Chamnong noted that management rather than ownership was often a better guide to performance.[67] One of the authors reached similar conclusions for France.[68] Raymond Vernon in *The Promise of Privatization*, a cross-national collection of case studies of privatization, drew the following conclusion:

64. The industry type can also be important. Some industries, such as information technologies, may actually operate more efficiently as monopolistic public enterprises. Modern production techniques are dissolving traditional boundaries between private and public enterprises. One reason is that the cost of research and development for some technological industries has soared beyond the reach of most large private firms. Another reason is the nature of production of new information technologies. The lion's share of the costs of manufacturing these products lies in design costs, not actual production costs. Once one computer is produced, average cost declines for each computer thereafter. As a result, competition among firms occurs in the design stage, not in the production stage. This results in the "Balkanization" of knowledge; technological information becomes proprietary. Technology is diffused across competitors rather than the development of a unified operating system. A perfect example is machines that do not easily talk to one another, like Apple and IBM personal computers of the 1980s. In the United Kingdom, privatization of the telecommunications industry precipitated a confusion of different systems and standards in the industry. France, on the basis of planned, state-owned development, took the lead in size and quality of its telecommunications network. By 1983, the size of the French network exceeded that of the United Kingdom. Furthermore, the French system is the cheapest in Europe. *C.f.* Nicholas Costello et al., *Industrial Restructuring and Public Intervention: Planning the Digital Economy*, *in* THE ECONOMICS OF RESTRUCTURING (Jonathon Michiel ed., 1991).

65. R.E. Christiansen, *Editor's Introduction*, WORLD DEV., May 1989, at 597.

66. Heidi Vernon-Wortzel & Lawrence H. Wortzel, *Privatization: Not the Only Answer*, WORLD DEV., May 1989, at 633, 633-40.

67. Vudhichai Chamnong, Integrated Summary of the Conference, Presented for the Asian Productivity Organization's Management Dynamism in State-Owned Enterprises in Asia (1989).

68. COHEN, *supra* note 63.

> [T]he glaring cases [of differential performance between state-owned and privately owned industry], however, have revealed much more about the basic character of the government involved than the efficiency potential of state-owned enterprises. Where governments have been reasonably competent and responsible, and where comparisons between private enterprises and state-owned enterprises has not appeared much different than private enterprise. Here, and there a strikingly efficient performance by a state owned enterprise has cast doubt on the simple stereotypes of the public enterprise as a perennial wastrel.[69]

What these examples suggest is that reliance on the public sector, and public ownership in particular, may actually be good strategy. State ownership is certainly not to be sought as an end in itself; nor, for that matter, is private ownership of large enterprises. It all depends upon the context in which choices must be made. Where private ownership seems doomed to fail—as in the case of many large enterprises in Eastern Europe—the failure will result in a sudden implosion of the economy and society. In these cases, alternatives to simple privatization should be sought. After all, even mighty Western Europe did not turn over its inefficient, traditional industries to the tender mercies of the market. Steel, coal, rails, telecommunications, and agriculture were nurtured for years in various ways by the state, which calculated that the costs of sudden collapse and disruption exceeded the costs of inefficiency. State ownership has absolutely no a priori claim as the most efficient choice, but neither does it, by itself, doom industrial growth. Sometimes, such as in unkind times, state ownership may be a good second best alternative; it may help enable enterprises to "buy time" to catch up with more technologically advanced competitors. Moreover, the recent surge of privatization throughout Europe, Japan, and the Third World indicates that state ownership need not be a permanent phenomenon. Those trying to design new systems for Eastern Europe might profitably sift the rich varieties of institutional experience of other countries to glean what lead to better or worse performance: from state-owned, state-regulated, state-controlled, or the state-in-cahoots-with the company models. Ownership is a complex concept, contingent on embedded institutions. And, given current conditions for big industry in Eastern Europe, state ownership may be more desirable than simple "private ownership." The conclusion argues that the logic of privatization in Eastern Europe does not ensure a dynamic market economy dominated by private firms. It is more likely that rapid privatization will precipitate state reintervention sooner or later.

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69. RAYMOND VERNON, THE PROMISE OF PRIVATIZATION: A CHALLENGE FOR U.S. POLICY 4 (1988).

VI. Conclusion: The Faulty Institutional Logic of Rapid Privatization

The focus on privatization, especially rapid privatization, diverts attention from the implementation of policies and the creation of market firms and institutions that encourage the development of competitive industries and an effective state bureaucracy. More important than the expected benefits of increased efficiency in its big firms as a result of privatization, Eastern Europe needs to rebuild the networks of industrial linkages and trade within the region. It needs outlets for its goods—especially agriculture to Western Europe. It will need import controls so that all savings will not wash out quickly in a wave of consumer buying. And it needs a competent and honest public administration to re-create those international linkages, administer those controls, negotiate trade agreements, regulate the new and wildly imperfect markets, and buffer the vast shocks of fundamental industrial restructuring.

To the radical capitalists, rapid privatization is a shortcut. Eliminate the state, and voilà, economic growth. But this belief is a myth. The state will not wither away, despite the dreams of the radical capitalists, any more than it did in the dreams of Karl Marx. The state will run things for a long time, if not as owner, then as regulator.

Ironically, the logic of rapid privatization does not make the dependence of industry on the state any less likely. The state is destined to be the key player in the economy for the foreseeable future, whether privatization is rapid or gradual. The newly privatized enterprises will depend on the state for financing, but they will also need the state's political goodwill for establishing favorable rules and regulations. Moreover, an interventionist state is mandatory as enterprises struggle with the process of creating firms that can survive under a market system. The state will also maintain a heavy hand in the industrial core of the economy because, in Eastern Europe, the inherited industrial structure provides most industries with too few firms for successful self-regulation by competition. Moreover, regulation by foreign competition may prove fatal.

Just as substantial state involvement in the economy is inevitable, given rapid privatization, so is protectionism. Newly privatized enterprises unfit for foreign competition are likely to press for protectionist measures, especially since an open domestic economy would be suicidal for local producers. Free competition would open the field for Japan, the NICs, and other low-cost, high-quality producers and would leave little chance for inefficient domestic producers. They are inefficient now, and by world standards, they will be inefficient and uncompetitive for the foreseeable future. One must recall that Japan, Korea, France, and Germany did not expose their "infant industries" to the rigors of foreign competition; neither will Eastern Europe.

Finally, rapid privatization plans are not necessarily conducive to narrow, active and independent ownership. Some rapid privatization plans envision ownership through mutual funds or through national distribution of share vouchers. In either case, there is no guarantee that active, independent ownership pressing for dynamic restructuring will emerge. Mutual funds owning shares in many firms, as in the Polish plan, may react to poor performance by selling shares, not necessarily by restructuring industry. If they do not, or are not allowed to, they become, de facto, more like Italy's IRI than a Wall Street fund. More importantly, the mutual funds (even with foreign advisors) are likely to advocate conservative measures for change because of the dependence of enterprises on the state, and perhaps ultimately on the workers. Also, it is not obvious why widely dispersed ownership, as in the Czechoslovak plan, will pressure enterprises to restructure. The new small shareholders are more likely to remain passive, perhaps feeling cheated in their investments, as enterprises fail while some insiders get rich.[70] In any event, most big, inefficient enterprises will remain in state hands, directly or indirectly, for the time being.

Grand designs are associated with great risks; so it was with Communism, so it will be with liberal capitalism. But the risks associated with rapid privatization skew the odds toward failure and ultimately toward disenchantment with capitalism and a democratic, more liberal state. Why take the risk? We don't see a good reason. The big, inefficient enterprises will not succeed as private enterprises. But they cannot simply be abolished. In order to get a functioning market system up and running in Eastern Europe, it will be necessary to keep the state involved in the economy, if for no other purpose than to preserve a space to maneuver and take positive action. The structures of capitalism, the institutions of a functioning market system, must be built. That will take time, and breathing room. Radically pure markets will not build them; they will destroy those structures and risk ending the capitalist experiment before it has had a chance to develop into something worthwhile. After all, it was Joseph Schumpeter, the great advocate of entrepreneurial capitalism, in his brilliant case for maintaining less than perfect markets, who remarked, "You put brakes on a car so that it can go faster, not slower."[71]

The radical capitalist fallacy is that gradualism will ultimately result in the loss of grand vision as local interests forestall change. Their concern is valid, but their prescription is not. Quite the reverse, in fact, is true. Rapidly privatizing inefficient enterprises will increase long-term dependence on the state, while deliberate restructuring will set the stage for firms to embark on their own. Both experience and logic argue that intermediate forms of ownership, sometimes involving the state, may be instrumental in a country's growth. Nonetheless, over

70. Buoyed by investment firms promising a tenfold return in a year, Czechoslovaks have flocked to the voucher plan. The World Bank reports that "[m]ore than half of Czechoslovakia's 15.5 million people have registered to become shareholders . . . [and that] the process involves industrial assets with an asset value of $9 billion." *Milestones of Transition*, TRANSITION, Feb. 1992, at 11.

71. SCHUMPETER, *supra* note 1, at 88.

the short-term there is no choice—the state will be the key player in the economy. It is the state that will make the crucial economic decisions. Rapid privatization of big, inefficient enterprises is not so much the wrong answer as the wrong question. Too much attention, too much energy, and far too much political capital is being devoted to their privatization and not enough to more pressing, but less glamorous issues like enterprise restructuring, the creation of credible legal or tax systems, the rebuilding of a regional network of industrial and market linkages, and the creation of a functioning, reliable state administration. These are the key pieces. Future accounts of economic change in Eastern Europe are likely to characterize big enterprise privatization as myth, or perhaps more accurately, as fad.