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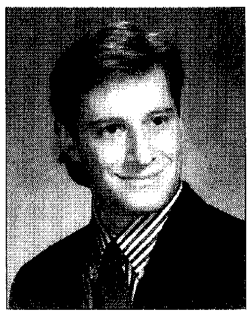

Introduction

When the wave of economic, social and political reform swept across the European continent in the late 1980's, Czechoslovakia was catapulted from behind the darkness of the Iron Curtain into the daylight of the Western World. This new light was very revealing for the Czechoslovaks as they realized that their country, among the leading industrial nations in the 1930's, had been decimated by four decades of communist rule.

Now with the collapse of the communist regime, Czechoslovakia must put the past behind her and prepare for the future as she embraces democratic ideals and ushers in a new economic era. The task at hand for Czechoslovakia seems almost insurmountable: transition from a centrally-planned to a free-market economy. Among the many changes in this transition period is the most critical element, the re-privatization of Czechoslovak industry nationalized under the communist rule.

In the sections of the paper which follow, I will discuss the process that the Czechoslovak government has undertaken in order to restructure the economy. This process includes the restitution of former privately owned property, the privatization of nationally held businesses, and the overall restructuring of industry.

History of Central Planning

The Czechoslovaks have had a long history of successful industrialization. Even before the 20th century Czechoslovakia proved herself to be a leading industrial nation. The Czech lands had been industrially the most developed part of the Austro-Hungarian Empire, which collapsed in 1918; and a complete market system had developed in an independent Czechoslovakia [except for the time it was under German occupation] until 1948.

By 1948, Czechoslovakia had become the most industrialized nation in Eastern Europe. The per capita income in Czechoslovakia that year was $176 (in 1948 US dollars) compared to $112 in Hungary, $104 in Poland, $70 in Romania, and $68 in Bulgaria. Also, the percentage of the population that depended on agriculture for a living was far lower in Czechoslovakia (33 percent) than in any other

Eastern European country. (Smith, p. 18) It follows that more of the population of Czechoslovakia was dependent on industry than any other Eastern European country. Clearly, the Czechoslovak economy could have served as a model for the other Eastern European countries at the end of World War II, since its industrial sector was one of the most developed in the world.

However, in 1948 everything changed. The communists took over power in Czechoslovakia and started to build a socialist society. Nearly every industry was nationalized, and a centrally-planned economy was installed. The communists saw a rapid redistribution of property as a basis for the introduction of this new economy.

As the independent country of Czechoslovakia became a satellite of the Soviet Union, relations and trade with the West were cut off. Those in power in Moscow determined the output of Czechoslovak industries. This development of a socialist society was along the lines of the Stalinist method of industrialization, which consisted of the wholesale nationalization of industry, the establishment of a planning bureaucracy, and the institution of a state monopoly of foreign trade. (Smith, p. 29)

The Communist Philosophy Displayed in Czechoslovakia

In accordance with communist ideology, all government actions were undertaken on behalf of the workers with the ultimate goal being the equitable redistribution of income. The state gradually assumed control of virtually the entire economy, and by 1955 the nationalization of the economy was complete. Most small family businesses, private crafts, and service establishments were either liquidated or nationalized and integrated into larger state-owned enterprises. With the elimination of competition, the communists stressed the quantity of produced goods instead of the quality.

As a result of the state takeover, the entire economy changed. Between 1948 and 1960, the state's share of production of the net material product increased from 65.5 percent to 93.4 percent, while the private sector's share dropped from 33.4 percent to 1.6 percent. (Mejstrik, July 1991, p. 32) By 1986 the share of the state sector of the economy, in value added terms, was 97 percent as the government had taken over the industry of the entire nation. (Clark)

As a result of this shift in production from the private to the public sector, the growth rates of both productivity and output fell. The average annual growth rate of gross industrial output steadily declined from 10.9 percent per year in 1951-55 to 3.5 percent in 1980. (Smith, p. 41) Furthermore, Czechoslovakia soon lost its leading industrial status among European countries because of the low quality of its products.

By November 1989, it was clear to the people of Czechoslovakia that change was necessary, and thus they revolted against the communist regime. On June 8-9, 1990, the first free elections in over 40 years were held, resulting in a legislature dominated by President Vaclav Havel's Civic Forum and its Slovak ally, Public Against Violence. (Prust, p. 5) With a democratic government in place, Czechoslovakia set its sights on reforming its economy. It was obvious that drastic measures had to be taken to dismantle the system of central planning and to privatize and restructure the nation's industry.

Goals of Privatization

The course chosen by the new Czechoslovak government is similar to that chosen by other Eastern European countries: the transformation of the centrally-planned economy to a market-based economy through privatization and restructuring. However, the problem is not merely one of building capitalism, but rather one of building capitalism from the wreckage of an existing, though badly functioning, economic system. ("From Marx to the Market," p. 11)

Fundamental to a market-based economy is a system of private ownership; therefore, the main objective of privatization in Czechoslovakia is to spread ownership as widely as possible. However, according to Michal Mejstrik of The Institute of Economic Science of Charles University, the reformers face an economy that had been created with administrative goals, not economic goals, in mind. Thus, the economy currently consists mainly of large state monopolies with virtually no private sector. Consequently, the envisioned scale of privatization is enormous. The purpose of this transformation is the full or partial privatization of the large state-owned firms as well as the development of a completely new private sector of small and medium-sized firms. In accomplishing these goals there are many factors that will eventually shape the outcome.

Factors That Will Influence Privatization

The first factor, foreign investment, will be a key one in the privatization process. As of 1991, the value of the Czechoslovak state's industrial assets was estimated to be four trillion crowns (about $133 billion), with Czechoslovak savings amounting to only 275 billion crowns (about $9 billion). (Ash, p. 11) It is clear that with such limited resources, Czechoslovakia will require foreign capital to upgrade, recapitalize, and restore its infrastructure.

Along with the infusion of foreign capital, the formation of a market economy will also require the development of a spirit of competition and entrepreneurship. For consumers, competition means more alternatives in price and quality of goods. However, competition has been absent in Czechoslovakia for forty years since the Soviet Union had been the main importer of Czechoslovak goods, regardless of their quality. There was no need for Czechoslovak industries to be advanced and in step with current technologies because it would have given them no advantage in selling their products. For example, the Czech locomotive factory CKD did not change significantly the design of its locomotives for nearly 40 years.

Another important consideration in the success of Czechoslovakia's privatization is the speed at which the process occurs. Many enterprises in the Czechoslovak economy have equipment and plants that are badly outdated. The sooner these companies are privatized, the sooner new capital can be infused and the sooner they can become competitive. But politics will influence the speed at which this process will be able to occur. Many Czechoslovak workers lack the skills needed in a modern economy, and so many will have to be retrained. Thus, during the transition period, unemployment may well increase; and this will in turn put serious political pressure on the government. It must be remembered that for the past 40 years, the Czechoslovak people have not experienced any significant unemployment. However, in 1990 alone the number of unemployed persons rose from 5,000 to 80,000. (Czechoslovak Federal Republic, p. 1)

In making the transition to a market economy, the government must also look at the long-term role of Czechoslovakia in a unified European economy and in a global economy as well. The Czechoslovak economy will be expanded from serving as simply a supplier to the former Soviet Union to having all of Europe and the Western World as a market. Czechoslovakia can look to the rest of Europe for advice on this process. Other economies such as Poland and Hungary have already started down the privatization path, and Czechoslovakia will be able to learn from their mistakes. Another potential source of help could come from Westerners seeking to invest their capital. In fact, sizeable capital inflows will be key to modernizing all of Eastern Europe, which still is crippled by $60 billion in foreign debt and decades of communist misrule. ("Reawakening: A Market Economy Takes Root in Eastern Europe," p. 51)

The final element that will help to shape the course of privatization is the social conscience of the government. The goal of the transformation is clear: spreading ownership as widely as possible. The hope is to distribute shares among citizens in roughly equal portions and thereby offer everyone a minimum level of income from capital. But beyond that privatization is also seen as a crucial step in building a civil society based on personal rights and responsibilities and in creating a large entrepreneurial class. One social objective of privatization, not just in Czechoslovakia but in many former Eastern Bloc countries as well, is to compensate citizens for the years of forced savings, low consumption, and personal sacrifices needed to accumulate the capital that is now in the state sector. (de la Dehesa, p. 2)

Knowing that there are many factors that influence privatization, the government must warn the Czechoslovak citizens that there will be setbacks along the way. Building capitalism will be painful. But none of these setbacks should deter the government from establishing free markets.

The Process of Privatization

Although the goals of privatization are clear, the method of attaining these goals is a bit more complicated. As Lindley Clark says, "You can't just declare that you have a free-market economy and make it so." (Clark, 1991) Through a series of new laws, the current Czechoslovak government has laid out its privatization plan. But before any privatization can actually occur, the Czechoslovak government is committed to restitution of property privately owned before the communist coup. Once fair restitution has been completed, privatization of the economy can follow.

Privatization will occur in two stages. In the first stage small shops, hotels, and small businesses will be sold by public auction. The second stage is intended to privatize large state-owned enterprises. This will occur on an individual basis with each state enterprise proposing its own privatization "project." These projects could include public auctions, the sale of shares in the firm, direct sale, joint ventures with foreign enterprises, or a combination of any of these methods. The idea is to allow the current management of an enterprise to decide which method is best for that individual firm, thereby removing that responsibility from the government.

Restitution

Unique to the Czechoslovak reform is its undertaking of restitution. From 1945 through 1948, the pre-communist government nationalized much of the nation's privately owned assets, including most large industries. Then, when the communists took over in 1948, many small assets (real estate, barber shops, restaurants, etc.) were expropriated without compensation. The current government's desire to see private ownership succeed will only be credible if there is fair restitution or compensation for the property seized by the former regime. If private ownership is the ultimate goal, restitution is a very important symbolic first step. In essence, the new government is admitting to the faults of the past communist regime.

Only the assets nationalized after 1948 are subject to restitution according to the Restitution Law of October, 1990. Finance Minister Vaclav Klaus estimates the properties involved will be worth some 300 billion crowns (about $10 billion). And as parliamentary deputy Rostilav Sejuk predicts, restitution will affect about 6 percent of the country's worth. ("Czechoslovakia: Major Obstacle Removed")

The restitution procedure is quite simple. If an individual can prove ownership, he can reclaim his property. The government set a deadline of October 31, 1991, for applications for restitution, after which any enterprise or property not claimed will be included in the privatization plan discussed below.

Problems with Restitution

There are many problems with the restitution plan, most of which revolve around the relative question of fairness. The first problem is that restitution does not extend back to the early days of nationalization in Czechoslovakia, in particular to 1939 when property was taken from the Jewish community by the Germans. Another problem is that many people whose property had been seized have since emigrated from Czechoslovakia. The new law requires that an emigrant must return to Czechoslovakia and reside there permanently if he is to be entitled to restitution.

Furthermore, full and exact restitution is not always possible. For example, suppose that a small enterprise was nationalized in 1959 but that today it has turned into a large corporation. Since the government cannot return the now larger enterprise to its original owner, restitution must be made in the form of appropriate compensation, rather than through the return of assets. Appropriate compensation could come in the form of a monetary lump sum, partial ownership of the enterprise, or some other equitable compensation.

Many other problematical situations involving restitution exist. Suppose, for example, that a farm was nationalized and that now another family is living on that farm. Should the government remove the new residents of the farm, perhaps displacing a whole family, just to give the previous owners, or perhaps their heirs living in another country, a fair settlement?

The difficulty of proving ownership also seems to be another problem with the Restitution Act, especially forty years later when many legal documents may have been destroyed or are missing. The government has decided that since the details of each restitution are so different, they will be decided on a case-by-case basis.

Small Privatization

Once the government has effected proper restitution, the privatization process can continue. The Small Privatization Act of Czechoslovakia was enacted on December 1, 1990. As mentioned earlier this act governs the privatization of small enterprises, such as retail outlets, restaurants, small hotels, beer halls, and service companies, all of which were nationalized after February 25, 1948. As of August 1991, 8,000 small enterprises not subject to restitution had been privatized, 5,000 in the Czech republic and 3,000 in the Slovak republic. However, 100,000 such businesses have been scheduled for privatization, and the optimistic goal of completing the process within three years has been set.

According to the act, small enterprises will be sold at public auctions to the highest bidder who meets certain regulations. Thirty days before each auction, the privatization ministry of each district is supposed to publish the following:

1) the name and place where the auction will be held;
2) the name of the managers of the enterprise;
3) a list of the real estate, buildings, machines and equipment included in the auction;
4) the starting bid;
5) the date, place, and time of auction;
6) the place and manner of the deposit of the auction "caution" (a form of deposit to be explained below);
7) the amount of the credit line of the business.

Anyone intending to participate in the auction must prove that he has deposited the auction "caution" in the amount of at least 10 percent of the starting bid, with a minimum amount of 10,000 crowns (about $350). From this auction "caution" a fee of 1,000 crowns is deducted for the license to be present at the auction. After the auction, the deposits of everyone but the buyer are returned.

The auctions are to occur in two rounds if necessary. The first round is open only to Czechoslovak citizens (the auctioneer and those people involved representing the republic cannot bid). The auction will begin with a starting bid equal to the price of the real estate, machines and equipment, other production essentials, etc. If the business cannot be successfully auctioned by this procedure and if at least five people are present at the auction, the auctioneer is then supposed to decrease the starting bid in 10 percent increments, with 50 percent of the original bid as the lowest that he is allowed to go. If the business cannot be successfully auctioned after this procedure, the first round of the auction will be complete. The second round of the auction is similar to the first round except that during this round foreigners are allowed to enter the auction. Also the minimum bid which the auctioneer can accept is 20 percent of the original starting bid.

Problems With Small Privatization

The auction process presents many problems, not the least of which concerns the issue of fairness. Who in Czechoslovakia has the capital to purchase any of these small enterprises? One such group is the *nomenklatura*, those who were well compensated under the communist regime. Others who will be able to buy their own businesses are those who acquired money illegally during the communist rule.

Aside from these groups, however, few Czechoslovak citizens will be able to purchase property, simply because most lack the savings to do so. Moreover, Czechoslovak banks may be reluctant to extend loans since most people also lack collateral. Even for those lucky enough to get bank loans, the high current interest rates severely hamper opportunities for profit. In addition, many people simply lack the desire to become entrepreneurs. Many are unaware of what owning their own business can be like and fail to realize that a profit can be made if a person is motivated and willing to work hard.

Even for those who are interested in becoming entrepreneurs, the privatization laws still present certain problems and obstacles. One such problem is the requirement that a new owner must retain all current employees of an enterprise or else pay them severance pay equivalent to five months salary. This means that even those workers who had held unnecessary or unproductive jobs under the former government still must be paid their salary. This could be very costly, especially since communism was "so good at assigning workers and capital to jobs that made no sense." ("Creating the Invisible Hand," p. 64) Another factor that limits the potential for profit is the shortage of experienced managers. Unfortunately, there are few people with the practical experience of running an enterprise with profit and quality as goals.

Determining the true value of enterprises also presents a considerable challenge to potential owners. So far, there has not been put in place an accurate accounting system that would allow a bidder to review an enterprise's balance sheet, examine sources of revenue, analyze product markets, etc. Taken together, all of these factors make it very difficult for the government to stimulate an entrepreneurial spirit in its population.

There is one final problem with the privatization efforts so far. There are currently thirteen privatization committees in the country, all exercising control over their own respective districts. Some of these committees are sponsoring auctions only for the right to rent a business for 2-5 years. The local governments would control the rent, and ownership would remain in the hands of the state. Incredibly, in these rent-only auctions, the rent is not always disclosed to potential bidders. However, an amendment to the Small Privatization Act is expected which would make the rent-only auction illegal.

Large Privatization

Czechoslovakia's Large Privatization Act, passed on April 1, 1991, governs Czechoslovakia's plans to privatize about 7,000 large enterprises in three to four "waves" starting on January 1, 1992. In July 1991, the Czech regional government approved a list of 1,176 large companies to be privatized in the first wave, and about 1,120 other large companies will be privatized in the second wave, due to start in 1993.

According to the Federal Ministry of Finance, there are three major classifications of national property (A, B, and C) to be considered under this law. Category A consists of about 500 public utilities and other regulated state-owned enterprises that will not be privatized in these first two waves. (Mejstrik, January 1991, p. 15) This category includes such industries as telecommunications and transportation, which are operated by the government and are closely regulated. Category B includes state-owned "heavy industry" (B1) and "light industry" (B2) firms that will be privatized. Many enterprises in category B2 must be split up from their large monopolistic forms before they can be privatized as individual units. Category B2 includes most of Czechoslovakia's enterprises that were not covered under the Small Privatization Act. Category C, finally, will cover newly defined municipal property such as those that result from the splitting up of enterprises in category B2.

The method of privatizing large enterprises is different from that of small enterprises. Each large enterprise must prepare its own privatization "project," a proposal for the privatization of that business. The proposal is to include such detailed information as:

1) a description of the enterprise and the property which is the subject of the proposed privatization;
2) details of the way in which the state acquired the property including details of restitution claims;
3) a valuation of the property;
4) the proposed manner of privatization;
5) if a sale is intended, details of the terms of sale;
6) a timetable for the implementation of the privatization project. (Andersen Consulting, p. 5)

After drawing up its privatization project, the enterprise submits it to the Ministry of Privatization within that district. The Ministry has one month to react to the proposal and then passes it on to the National Ministry of Privatization, which must deliver its decision within two months. Thus, the potential buyer must negotiate with at least three parties: the management of the enterprise, the Ministry of Privatization of the district, and the National Ministry of Privatization. Final approval of the transaction is required from the National Ministry of Privatization. (Andersen Consulting, p. 5)

There are several different privatization options which a large enterprise could elect to include in a privatization proposal: to sell the enterprise directly to a citizen, to put the enterprise up for sale at an auction, to enter a joint venture with a foreign company, or to sell the enterprise through the "voucher" method (to be explained below). A company can choose whichever method it thinks will most benefit that enterprise to incorporate into its project. This includes a combination of two or more methods, such as a partial sale at an auction and a partial sale through the voucher method.

The Voucher Scheme

The voucher scheme is a much publicized and highly anticipated part of Czechoslovakia's privatization plans. A voucher is a security bearing a person's name which entitles that person to bid for shares in state auctions of designated enterprises. The voucher scheme is an attempt to distribute to every citizen a share of equity in the enterprises being privatized.

Vouchers can also be used to purchase shares of any of the joint stock companies, or to acquire participation in financial institutions that hold a broad portfolio of shares. The potential amount of capital involved in the voucher method of privatization is enormous. All state-owned enterprises will have some marketable shares, and anywhere from 20 to 100 percent of a company's equity could be available for voucher sale.

A voucher is not transferable—that is, it cannot be sold—but rights to it can be transferred to an heir. Every Czechoslovak citizen, 18 or older, is entitled to purchase these vouchers for a nominal fee of 1,000 crowns (about $350). The idea is that citizens will use their vouchers, worth at least 85,000 crowns (about $2800) each, to buy equity in companies that appeal to them. (Ash p. 14) The government will auction off the equity of a company with each voucher being a bid. The equity of a company will be divided among those who bid on it.

This voucher scheme is one of the most original and controversial elements of Czechoslovakia's transformation. Vouchers would transfer a significant proportion of the state's assets into the hands of the public for very little cash. If the plan succeeds, most Czechoslovak citizens will be shareholders in enterprises of their choice. The goal of this plan is to benefit all citizens equally, since the state was not considered to be the owner of these enterprises under the communist regime, but rather the people were. The communist government was just controlling the assets on behalf of the people.

However, there are some problems that may hinder the success of this proposal. As mentioned before, many citizens seem ignorant or simply uninterested in owning shares of enterprises. Many people (including all persons under the age of 45) have never experienced private ownership in a market economy. They might not be willing to give private ownership a chance.

There are other potential problems as well. Since many of the enterprises to be auctioned have unknown value or potential, the quantity of bids that an enterprise receives might not be an accurate representation of its true value. To provide a more accurate representation of the value of a share, the reformers know that a stock exchange of some kind is ultimately essential for the success of the voucher privatization scheme. A stock exchange would allow people to buy, sell, and trade their shares, and would also provide a method of comparing the worth of one company to another.

Conclusions

This paper has discussed the three aspects of the privatization of Czechoslovakia's industry: restitution, small privatization, and large privatization. Restitution will return private property taken by the communist government to previous owners. After that is complete, small and large privatization will distribute the remaining enterprises into the hands of private owners.

The new government of Czechoslovakia has set its privatization goals very high. However, the road to success presents many challenges, and there are many questions that remain. Will the Czechoslovak people realize the necessity of becoming involved in the privatization process? Will they realize that these reforms will be very difficult in the short run? Will the nations of the West help Czechoslovakia with their capital and experience to establish a free-market economy? Perhaps the ultimate question though, is whether the people of Czechoslovakia will endure further sacrifice so soon after attaining their freedom and allow the current government the necessary time to help Czechoslovakia regain her former industrial status.

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