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The Merits of Insider Privatization

What Russia Can Learn from Eastern Central Europe

by Ralph Heinrich

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- The debate on the privatization of enterprises in Eastern Europe often presumes that enterprises are still controlled by an identifiable entity called "the state". This, however, is no longer the case. Since the demise of tight central planning, the nominally state-owned enterprises are de facto steered by insiders such as incumbent managers, workers, and local administrators. As the customary property rights of insiders are not legally acknowledged and are thus not secure, insiders tend to adopt a myopic attitude and neglect the long-run profitability of their firms.
- Centrally organized privatization programs to disburse ownership rights to non-insiders are usually advocated as the best way to improve the efficiency of the firms. However, such privatization programs challenge the present position of managers, workers, and local bureaucrats. The insiders therefore tend to resist the privatization programs. If the central government cannot quickly decide the ensuing power struggle in its favor, the establishment of secure and tradable private property rights is delayed and the performance of the enterprises may deteriorate even further in the meantime.
- The extent to which a central government needs to take the customary property rights of insiders into account in the design and implementation of its privatization policy depends on its political power. Whereas the government in former Czechoslovakia had been able to largely disregard the claims of insiders, governments such as the Polish one have been far less successful. The evidence supports the conclusion that a weak central state is ill posed to rapidly and successfully implement privatization strategies that disregard the customary rights of insiders.
- In Russia and most other successor states of the Soviet Union, the central authorities are in an extremely weak position relative to enterprises and local administrations. In order to privatize quickly, Russia should largely respect and formalize the customary property rights of insiders and make these rights tradable. Although Russia's present privatization approach grants managers, workers, and local bureaucrats more say in the privatization process than the respective programs in Eastern Central Europe, Russia would be well advised to enhance the preferential conditions for insiders even further and to scale down the scope of its voucher program.
- The criticisms voiced against insider privatization are not convincing. They either refer to general problems of the transformation process that no privatization method could avoid, or the criticisms refer to problems that only arise if insider privatization is deemed illegal by official policies that do not take customary property rights into account and that do not make the property rights openly tradable.

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I. Introduction

The privatization of existing state enterprises remains one of the most important and controversial aspects of the transformation process in post-socialist Eastern Europe. In the economic debate, the central points of contention are the appropriate speed of the ownership transformation, the groups of society that should be favored or excluded as new owners, the methods of establishing effective corporate governance, and the appropriate pricing of the assets. In the political debate, the issue is particularly sensitive. The disbursement of ownership rights in state enterprises constitutes a major redistribution of existing assets (although the net worth of the enterprises has often turned out to be less than expected).

Three years of fundamental economic reforms in Poland and Hungary and two years in former Czechoslovakia (CSFR) now enable us to go beyond the initial theoretical discussion and to draw some empirically-based conclusions for the privatization efforts of late-comers such as Russia. Whereas new private firms have grown rapidly in Eastern Central Europe ("privatization from below"), the privatization of existing enterprises ("privatization from above") has so far proceeded at a much slower pace than governments intended. Problems of asset valuation, the inadequate administrative infrastructure, and the lack of markets for risk diversification are usually quoted as major reasons for the delays. In this paper I will go one step further and argue that one of the premier reasons for the delays in the privatization of medium-sized and large enterprises is a struggle between the state and enterprise insiders (mostly managers and workers) over the initial distribution of property rights. This conflict has been costly because it has postponed microeconomic adjustment and increased the inefficiency with which firms are being managed in the meantime. A potentially even more damaging struggle may now loom in Russia where the government has also embarked on an ambitious program of top-down privatization.

The main conclusion of this paper is that, under conditions of an extremely weak central authority such as in Russia and other members of the Commonwealth of Independent States (CIS), the best privatization strategy is to buy off the resistance of insiders by recognizing customary property rights and officially granting insiders substantial ownership rights in their firms. Although the Russian privatization program goes further in this direction than other programs in post-communist Europe, Russia would be well advised to increase the element of insider privatization even further in order to avoid a protracted struggle for control over its state enterprises.

The paper is organized as follows: Chapter II challenges the standard presumption that an identifiable entity called "the state" can actually exercise ownership rights over the supposedly state-owned enterprises in Eastern Europe at present and discusses the importance of the customary property rights of insiders. Based on a brief evaluation of the privatization experiences of Eastern Central Europe (Chapter III), the paper makes the case for granting insiders a dominant role in the privatization process in countries such as Russia where the central state is particularly weak (Chapter IV). The subsequent Chapter V examines Russia's present privatization program. The major conclusions are summarized in Chapter VI. Although the discussion is

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mostly restricted to Russia as the most important case, the thrust of the theoretical arguments and the empirical lessons from Eastern Central Europe can be applied to other CIS members.

II. Property Rights at the Onset of Privatization

1. The Evolution of Property Rights in Centrally-Planned Economies

The discussion on the privatization of existing enterprises in post-socialist Europe is usually based on the presumption that the nominally state-owned firms are indeed under the control of an entity called “the state”, which can thus decide about the fate of the firms more or less as it sees fit. This presumption is misleading, though; it appears to be based more on a textbook description of an old-fashioned Soviet-type economy than on an analysis of the actual distribution of property rights in Eastern Europe. The following paragraphs will argue that the property rights situation is far more diffuse and that a rational privatization strategy needs to take the interests of those individuals into account which presently exercise *de facto* ownership rights.

On the most fundamental level, the problems of centrally planned economies can be traced back to the absence of strong individual incentives to use productive resources efficiently and to convey information on economic scarcities to other agents. In a textbook case of a Soviet-type economy, productive assets are *de jure* and *de facto* owned by the state. The state exercises its property rights through a rigid system of top-down central planning. Decisions are taken by party officials, state planners, and, to a lesser extent, by enterprise managers. However, the individuals who draw up, execute and control the plan on behalf of the state neither bear the full costs nor reap the full rewards of their decisions. The bulk of costs and returns of individual decisions over the use of productive resources accrues to “society” (which is sometimes officially called the owner of productive assets). “Society” being factually unable to exercise control, the property rights to productive resources are ill-defined in such a centrally-planned economy.¹

The term “centrally-planned economies” only loosely fits the actual economic mechanism, which used to operate in the economies of the former Council on Mutual Economic Assistance (CMEA) before the final demise of socialism. The rigid Stalinist central planning system had long ago turned out to be unable to cope with the technological shift away from large-scale heavy industry to more high-tech, small-scale production.² The reason was that the main task of the central planning apparatus, i.e., the allocation of resources among the many productive activities in the economy, became more complex as the number of goods increased, quite independently of the overall volume of production to be coordinated. Technological progress and the desire to expand the consumer goods sectors multiplied the number of goods to be produced and thereby the need for coordination [Nove, 1986]. The planning bureaucracies soon proved incapable of doing their job without severe failures. Due to the inflexibility of the system, minor inconsistencies often resulted in major disruptions of production. Roughly speaking, those managers and lower-level bureaucrats who could see what went wrong

¹ The costs of organizing would be prohibitive for the population as a whole. Interests are too diverse and each single decision as to how to use any particular asset is inconsequential to households. Thus, free riding would have to be expected. Of course, the socialist state never had the intention to let the population participate in running the economy to begin with.

² Under the system of large-scale physical planning, the Soviet Union at least achieved rapid industrialization, albeit at tremendous social costs. For Hungary, Poland and what used to be Czechoslovakia, who had already attained a sizable degree of industrialization prior to going communist, the system proved an almost unmitigated disaster from the beginning.

neither had the power nor the incentives to do something about it, while those top-level planners and politicians who had the power were largely kept unaware of the problems.

In response to mounting inefficiencies, the socialist economies moved away from textbook-type central planning over the course of time. The distribution of de facto property rights in productive resources changed. Even in countries which did not deliberately reform their economic system, the planning process ceased to work strictly from the top down. With the growing complexity of the division of labor, the iterative aspect of planning gained in importance: subject to the priorities spelled out by the party, the enterprises drew up plans and passed them up the hierarchies for approval. On the way up, these proposals were collected and aggregated until they reached a level authorized to make decisions. Planners at this level then passed down production targets based on — but not necessarily identical with — the aggregated proposals from below. The targets were disaggregated again on their way down the chain. Upon receiving the targets, enterprises returned requests for inputs. This process was repeated several times. A bargaining culture developed [see, e.g., Malle, 1992].³ But the gradual changes in the relationship between central administrators and firms did not prevent major coordination failures. The bureaucracy continually failed to finalize current plans ahead of the period of their implementation, and persisting inconsistencies led to many arbitrary amendments during the execution of the respective plans.

a. Socialist Reforms in Eastern Central Europe

In some countries such as Poland and Hungary, the spontaneous changes in the mechanics of central planning were deliberately fostered by conscious economic reforms. After the establishment of the *Solidarnosc* movement, the *Polish government* in 1981 allowed substantial decentralizations of enterprise decision making. Under the new system of self-management, employee councils were formally empowered with competences on hiring and firing managers, on determining basic enterprise policies, on setting wages, and on using profits. But the results were far from encouraging. In order to avoid conflicts with employees, the managers neglected investment, consented to excessive wage increases, and then lobbied the bureaucracies for new credits, higher output prices, and lower taxes. Growing macroeconomic instability ensued. The central authorities increasingly lost control of the economy as firms learned how to play off various levels of the hierarchy against each other and to exploit their vaguely defined and conflicting goals [Szomburg, 1991]. The result was a “balkanization of bureaucracy” [Swaan, Lissowska, 1992a]. The disintegration of central authority was further precipitated by its obvious lack of legitimacy following the imposition of martial law in late 1982. Under these circumstances, managers and workers’ councils de facto turned into owners of “their” firms. Unfortunately, this did not elicit an efficiency-oriented behavior since these de facto rights were neither legally acknowledged nor tradable.

The case of *Hungary* to some extent resembles that of Poland. The first attempts in Hungary at decentralizing enterprise decision making without abandoning state ownership were introduced in the 1950s. A more determined and encompassing effort was made in 1968 with the New Economic Mechanism [see Brus, 1986]. Although the reforms failed to replace bureaucratic forms of control with genuine market coordination, they at least created some room for marginal legal and semilegal private activity [Kornai, 1990]. In 1985, the introduction of enterprise councils in the majority of firms further weakened the control of central ministries. These councils were endowed with powers similar to the Polish employee councils but came to be dominated by management rather than workers. Enterprises became largely self-managed and enjoyed a considerable and growing autonomy. Central planning of physical quantities largely gave way to discretionary bargaining

³ Nove [1986, p. 98] speaks of “orders written by the recipients”.

between state administrators and managers of firms on prices, subsidies, and other special conditions for individual firms.

Unlike Poland and Hungary, *Czechoslovakia*⁴ kept its firms under tight central control, apart from a short episode of reforms during the “Prague spring” of 1968.⁵ The system of central planning by physical indicators was maintained basically to the eve of the 1989 revolution. The first post-socialist government inherited state enterprises, which were still used to being tightly controlled from above⁶ and which had not gone through a period of self-management or price liberalization. Thus, managers and workers could not lay claim to significant customary property rights.

b. Customary Property Rights in the Former Soviet Union

While in Hungary and Poland the ruling elites themselves initiated substantial deliberate decentralization “from above”, no major attempts of this kind were made in the Soviet Union until the late 1980s. To the contrary, starting in the Chruzhchev era, the growing pressure that planning failures exerted on the Soviet economy led to a series of attempts to reshuffle responsibilities among the numerous bureaucratic hierarchies drafting, executing, and supervising the central plan. Among other things, vertical and horizontal mergers were ordered in an attempt to alleviate the higher authorities of some of the complexities of planning. It is worth noting, though, that industrial ministries and enterprises themselves also found it rational to strive for the greatest possible vertical integration in order to achieve autarchy and thus to isolate themselves from the consequences of planning errors.

Over the course of time, the severe and worsening shortcomings of the planning system were somewhat mitigated by a process of spontaneous “quasi-private” ordering. In their desire to control everything, Soviet planners duplicated the major planning and supervising organs several times. Overlapping areas of competence were also common between industrial ministries. This very deficiency of the planning process afforded a growing amount of discretion to enterprise managers and lower-level bureaucrats. Enterprises frequently faced conflicting orders from different bureaucracies. This put them in a position to make their own decisions as to which orders to fulfil and to which extent. Despite the absence of major systematic reforms, a gradual decentralization of decision making had thus been at work for decades in the former Soviet Union [Nayshul, 1991].

A “complex network of informal relationships” [Nove, 1986, p. 105] developed between enterprise managers, bureaucrats, officials of the communist party, suppliers, and customers. The major purpose of this network was to cope with the problem of uncertain supplies of inputs. The system was based on personal contacts, reciprocal favors, and bargaining. As time went on, almost everything became tradable in what Nayshul [1992] has called the administrative market. Bargaining became possible over issues such as production targets, resource allotments, favors, rights to ignore orders, and positions in the hierarchies. In addition, an informal barter trade in resources developed between horizontal levels of different hierarchies and between enterprises. This *horizontal* bargaining again was a response to worsening bottlenecks caused by the remoteness of upper levels of the bureaucracy from economic reality. The isolation of top-level bureaucrats

⁴ Although Czechoslovakia ceased to exist on 1 January 1993, most of the developments related to in this paper precede the separation. I will therefore continue to use the term “Czechoslovakia” in reference to the Czech and Slovak republics.

⁵ For an account of the brief 1968/69 reform period, which featured many of the elements also present in the Hungarian approach, see for instance Brus [1986].

⁶ Albeit subject to qualifications similar to the ones applicable to enterprises in the Soviet Union before perestroika (see pp. 2 ff. in this paper and Mejstrik and Hlavacek [1991]).

grew with the increasing discretion that enterprises and lower-level apparatchiks achieved over the kind of information to pass on and whether or not to comply with orders from above [Murrell, Olson, 1991]. It must be stressed, however, that the degree of official decentralization achieved in the Soviet Union until the mid-1980s remained a far cry from the one realized in Hungary and Poland. The Soviet planning machinery retained enough influence to make sure that at least notional plan fulfilment remained the overriding concern of enterprises.

During the subsequent period of perestroika (1987–1991), the authority of the center was further weakened, especially with the 1987 law on state enterprises, which introduced forms of worker self-management [Johnson, 1991]. While the importance of vertical relations between firm managers, officials in ministries, and local bureaucracies seems to have declined considerably in recent years, bargaining between enterprises has become still more important for securing access to scarce inputs [Burawoy, Hendley, 1992; Filatochev et al., 1992].

The concept of ownership of assets involves three distinct rights: (i) the right to manage the asset, i.e., to decide to which use it is put, (ii) the title to the profits generated from the use of the asset, and (iii) the right to dispose of the asset, i.e., to transfer the ownership rights to third parties [Alchian, Demsetz, 1972]. When the Soviet Union collapsed, at least the first two of these rights did not rest with central authorities in Moscow anymore. What used to be state enterprises had either been claimed as *de facto* property by individuals or divided into spheres of influence among insiders on the basis of informal, unofficial customary rights obtained in the administrative market [Nayshul, 1992]. Customary rights of this kind can be very persistent and are amenable only to gradual change [see also Lin, 1989; North, 1992].

The erosion of central control finally became irreversible with the dissolution of the Soviet Union in late 1991, the prohibition of the Communist Party and the liberalization of most prices in the successor states of the Soviet Union at the beginning of 1992. Although almost all major enterprises in Russia are still nominally owned by the state, the entity called “the state” no longer effectively exercises control over the firms that it still nominally owns.

In such a situation, a privatization policy may appear to be obsolete. However, the replacement of effectively enforced state ownership by customary property rights does not remove the problem of ill-defined property rights completely. Substantial uncertainty about the actual distribution of customary rights over time arises. The fact that recognition and enforcement of customary rights to assets and resources depend on personal relationships greatly limits the number of possible partners for transactions.⁷ Since customary rights are often at odds with written law, a crackdown by the authorities on transactions based on customary rights can never be ruled out. Thus, the amount of worthwhile economic activity is also limited by contractual uncertainty.⁸ Replacing customary entitlements [Wiseman, 1991] by secure private property rights officially recognized and protected by the state should therefore be a premier task of economic reform. Even if firms are no longer controlled by the state, a privatization policy thus at least ought to remove the uncertainty resulting from the gap between the *de facto* and the *de jure* allocation of property rights.

⁷ To be sure, it can make sense in a developed market economy to voluntarily limit the number of possible partners for certain transactions by sinking specific investments in order to realize advantages of specialization. However, the gains from increased specialization must be paid for through an increase in transaction costs because specific investments need to be protected against opportunistic action [Williamson, 1985]. Where gains from specialization are lower than the additional contract writing and enforcement costs required to protect them, impersonal, anonymous exchanges are superior. It is in this sense that property rights backed solely by mutual trust and interdependence can be inefficient.

⁸ It should be noted, though, that plan inconsistencies and breakdowns of production made uncertainty as to whether a given contract would be fulfilled a pervasive problem of central planning from the beginning. The spontaneous forms of decentralization and vertical integration mentioned above are a response precisely to this problem.

2. The Importance of Customary Property Rights for the Design of Privatization Strategies

Privatization is the attempt to correct the central deficiency of (post-)socialist economies: the lack of individual incentives to use resources efficiently.⁹ In a textbook world, the only relevant efficiency criterion as to whom the property rights should *initially* be given to is that of organizing costs: it can be left to the market to find the best qualified owner for any asset as long as initial ownership is not too dispersed to permit negotiations with interested buyers. This view, however, abstracts from costs which may arise from conflicts over this initial distribution.

The effective distribution of customary property rights at the outset of the reform can be highly relevant for choosing the appropriate policy because these rights constitute a source of income to insiders. Any privatization scheme threatening the customary rights of managers, workers, and local bureaucrats must be expected to encounter their resistance. This can impose high costs on the economy for two reasons. First, managers and workers are not likely to actively pursue — potentially painful — adjustment policies in an enterprise if the probability is high that they will not be able to reap the benefits from these efforts. At the same time, outsiders, i.e., the government and/or potential outside investors, are not in a position either to implement restructuring measures, as long as insiders dominate the firm. Consequently, if insiders obstruct privatization policies, real adjustment will be delayed. Second, insiders will be tempted to adopt a myopic “sauve qui peut” strategy [Winiecki, 1992] and to run down the assets of their enterprise while they still can. They can do so by cutting back on investment outlays, piling up debts, raising wages beyond what the enterprise can bear, and by transferring assets to newly founded firms of their own.¹⁰

The extent to which a country needs to base its privatization policy on the initial distribution of customary rights depends on how substantial the costs of a conflict with insiders are likely to be. This in turn will depend on the political power of the state.¹¹ Whereas a strong state may well be able to disregard the claims of insiders, a weak state is ill posed to rapidly and successfully implement privatization strategies which do not respect the customary rights of insiders. The above analysis is substantiated by evidence from Eastern Central Europe presented in the next chapter.

III. The Privatization Experience of Eastern Central Europe

1. Former Czechoslovakia

Czechoslovakia's “velvet” revolution of late 1989 meant a complete and immediate shift in political power to new elites. Thereafter, managers who owed their jobs to the communist nomenklatura system enjoyed neither clout in the new political establishment nor substantial support in the population. The political cost to the new government of rapidly breaking resistance to privatization on the part of enterprise insiders should therefore

⁹ For a good discussion of the relevance of privatization for institutional reform, microeconomic adjustment, and macroeconomic stabilization, see, e.g., Hinds [1990].

¹⁰ The significance of this latter behavior will be examined in Chapter IV.

¹¹ Skaperdas [1992] offers an operationalization of the concept of power in terms of opportunity costs of non-cooperative behavior. A powerful government would then be one who could quickly force its privatization program on enterprises without jeopardizing its own political future. See also Poznanski [1992] for an elaboration of the determinants of the power of governments and its relevance in the transition process.

have been very low.¹² And indeed, what little insider resistance there was successfully overcome by the Prague government. After two and a half years of preparation, formal ownership transformation is now progressing smoothly and rapidly in former Czechoslovakia.

The centerpiece of Czechoslovak privatization has been the voucher system,¹³ under which Czechoslovak citizens can acquire shares of several thousand large enterprises at nation-wide auctions. The first of two scheduled waves of these sales has been completed successfully in the second half of 1992.¹⁴ The scheme involved neither a preferential treatment of managers or workers in the auction process nor any up-front concessions to induce enterprises to participate. Although Czechoslovakia allowed managers to prepare proposals for the privatization of their enterprises, any interested outsider could hand in a proposal as well. The final decision rested with the designated state authorities. Interestingly, 80 percent of the privatization projects included in the first round had been proposed by managers. This indicates that even the Czechoslovak authorities wanted to avoid conflicts with insiders for the time being to ensure at least a smooth start of the voucher program into which the government had invested a considerable proportion of its reputation. Yet, the authorities of Czechoslovakia (and, by now, the Czech Republic) appear to be strong enough to control the behavior of insiders and to continue with their chosen approach.¹⁵

Of course, the rapid and smooth completion of the first wave of voucher privatization does not yet imply that the enterprises involved possess an ownership structure conducive to rapid restructuring. The final success in terms of improving the efficiency of firms will depend on the behavior of the private investment funds, which control the majority of shares sold in the voucher program. Nonetheless, the experience with the first round supports the view that if enterprise insiders cannot claim substantial customary property rights, and if the state is in a politically strong position, the economic costs of a centrally administered privatization program allocating ownership titles without regard to the interests of enterprise insiders remain tolerable.

2. Poland

In contrast to former Czechoslovakia, enterprise insiders in Poland could claim to possess relevant customary property rights. Although the political revolution in Poland in 1989 entailed a complete shakeup of the ruling elites, the state still remained weak with respect to enterprises. Polish state enterprises are dominated by employee councils, which in turn consist to a large extent of members of the Solidarity Trade Union. Since it was Solidarity who first challenged the communist regime and who led the way to the revolution, employee councils are finding open ears in the Sejm for their concerns. Predictably, the privatization of larger enterprises has been sluggish in Poland even by East European standards [see, e.g., Winiecki, 1992].

The Polish mass privatization program, which has been discussed since late 1989, has so far failed to get off the ground. Under this scheme, several hundred state enterprises in good financial condition are supposed to be transformed into joint stock companies. Upon this transformation, employee councils are to be abolished,

¹² This is true in particular since workers in Czechoslovakia had never been actively involved in the running of state enterprises. They thus did not possess significant customary rights.

¹³ The Slovak government recently announced that it intends to scale down the voucher program in its second wave scheduled to begin in mid-1993 [see FAZ, b].

¹⁴ The first wave included almost 1,500 enterprises. On average, a little more than 60 percent of their book value was offered for sale against vouchers [MANPP, 1992]. The auctions were conducted in five rounds at the end of which more than 90 percent of the shares had been placed [East European Privatization News, 1993].

¹⁵ It should also be noted that there have been few reports about active asset mining during the period leading up to the auctions in Czechoslovakia.

thereby transferring the control back to the state as the majority shareholder.¹⁶ The shares of the firms are then to be transferred to a number of National Wealth Management Funds, which in turn would issue shares to the population at a later date. Although the scheme was introduced into parliament in 1991, not a single such fund has been set up until the end of 1992.

What little privatization of existing state enterprises there has been, has occurred mostly in the so-called liquidation path.¹⁷ This method involves the formal dissolution of state enterprises. Liquidated enterprises may be auctioned off in whole or in part, they can become part of a joint venture, or they can be leased by a private law company to be newly established by their employees. While firms which are unable to meet their tax liabilities can be forced into liquidation, the method can also be applied to other enterprises upon initiative of or subject to consent of the employees. The dominant role insiders are playing in the Polish privatization is well documented by the fact that they have ended up as owners or lessees in more than 80 percent of the *voluntary* liquidations [see Rzeczpospolita, 1992].

More importantly though, the Polish example also highlights the detrimental effects on enterprise performance of a protracted struggle for control. Survey results [see Dabrowski et al., 1992] suggest that the profitability of Polish firms has deteriorated during the privatization process. One reason is the excessive duration of the transformation procedure.¹⁸ This hurts the economy because adjustment efforts are typically suspended during the period of bargaining over methodological questions. The lack of outsiders capable of and interested in formulating an adjustment strategy coincides with the uncertainty of the employees over their future property rights. Consequently, the firm is kept in a protracted state of limbo in which even the initial capital may be consumed. Commercialized Polish firms, i.e., those transformed into private-law companies owned by the state, adopted a wait-and-see strategy. Early efforts at technological and organizational adaptation were clearly less pronounced in these firms than in those under voluntary liquidation. In cases where commercialization was not followed by an immediate sale of the shares to private investors, even the formal elimination of employee councils apparently did not result in any change of behavior or improvement of performance.¹⁹

3. Hungary

The starting conditions in Hungary exhibit parallels to the case of Poland. State enterprises have long escaped the rigors of physical central planning and enjoyed substantial discretion under self-management. Privatization of state enterprises started in a spontaneous way in 1989 and early 1990. Enterprises took advantage of the opportunity to set up new firms and to enter joint venture agreements. The new firm or the foreign partner then

¹⁶ As an inducement to participate, the program offers employees the opportunity to buy up to 20 percent of the shares at favorable conditions [Ministry of Ownership Changes, 1991].

¹⁷ By mid-1992, a little more than 1,700 out of roughly 8,500 Polish state enterprises had in one way or another entered the process of ownership transformation. Out of these, about 1,250 employed the liquidation path. All in all, 385 firms had completed their privatization, almost 350 of which in the liquidation path. The pace at which new privatizations were initiated decreased markedly in the first half of 1992 [Rzeczpospolita, 1992].

¹⁸ To some extent, the dramatic fall in profitability merely reflects the general downturn in the Polish economy in 1990 and 1991. The switch from central planning to market coordination initially destroyed the human capital invested in operating within the old system [Schmieding, 1992]. Inevitably, it will take some time to accumulate the — different — human capital necessary to take full advantage of the superior opportunities of the new coordination mechanism.

¹⁹ In terms of adjustment efforts, sales of firms to foreign investors seem to have been the single most successful cases [Dabrowski et al., 1992]. While in these cases insiders are basically giving up their property rights, they are being compensated by improved job security through the infusion of new capital, technological and marketing know-how, and better access to Western markets.

took over orders, assets, and employees of the state enterprise on favorable terms, often leaving the old enterprise behind as an empty shell. These activities must be viewed as attempts by insiders to secure their positions in a changing economic and political environment. Like in Poland, spontaneous privatization activities in Hungary met with severe criticism on grounds of fairness and justice [Crane, 1991; Gruszecki, Winiecki, 1991]. The government responded to these criticisms in early 1990 by founding the State Property Agency. This institution was given ownership rights over the 20 percent of Hungarian enterprises which until then had still been under direct state control. Furthermore the agency assumed the task of supervising all privatization deals, including those involving self-managed firms and small establishments in the service and retail trade sectors. The state thus tried to reassert its control over the privatization process; all privatizations now needed the approval of the agency.

Apart from a largely unsuccessful attempt to privatize 20 apparently promising companies by initial public offerings, the State Property Agency allows both enterprises and outside investors to initiate transformations, but retains the right to decide on the initiative and the method to be employed. The property rights acquired *de facto* by employees in the framework of the New Economic Mechanism²⁰ are being largely recognized by the provisions that the agency's decision on the privatization procedure is not binding for self-managed enterprises, that the founding organ and the employees have to be consulted on outside initiatives, and that employees of self-managed firms are entitled to 20 percent of the revenues generated by the privatization of their enterprise [Ministry of Finance, 1990].

Even this rather mild form of a reinforced state control over the privatization process turned out to be counterproductive. Due to complaints about the disappointing speed of the ownership transformation, a self-privatization program for small and medium-sized firms was introduced in the fall of 1991 [East European Privatization News, 1992]. This program allows small and medium-sized enterprises to perform their own privatization without direct government involvement. The only difference to the earlier forms of spontaneous privatization is that firms must work with a government-licensed private consulting firm. The government retains the right to withdraw the licenses of consultants if it does not think it is getting a fair deal. Also, insiders do not necessarily end up as owners under this program. Nonetheless, the program assigns a crucial role to the old managerial elite.²¹

Politically, it has been comparatively easy for Hungary's post-socialist authorities to grant managers a strong say in the privatization of their firms. Whereas Polish politics had been highly divisive since the imposition of martial law in late 1981, the incumbent political and managerial elite had been far less discredited and had even gained some grudging respect under Hungary's rather relaxed variant of socialism. After the demise of the socialist government, enterprise insiders have been strong enough to preserve far-reaching competences as to the privatization of their firms from the days of self-management,²² while the government has been strong enough to secure sizable revenues for itself. Privatization has been proceeding more quickly than in Poland. By mid-1992, roughly 15 percent of Hungary's state-owned enterprises but only 5 percent of their Polish counterparts had been privatized (excluding small privatization; for details, see

²⁰ For details on the New Economic Mechanism, see, e.g., Brus [1986].

²¹ Note also that the self-privatization program is an attempt to build on spontaneous activities (spontaneous privatizations and the sprouting of consulting companies). In this sense it can be seen as an instance of the government's legalizing natural or customary law, i.e., as an example of precisely the kind of legislative activity compatible with the process of spontaneous ordering [see von Hayek, 1973].

²² By mid-1992, more than 370 transformation proposals for enterprises had been accepted by the agency. Almost 330 of these had originated either from enterprises or from investors, while only in 44 cases (albeit concerning very large firms) did the initiative come directly from the state (information provided by the Institute of World Economics of the Hungarian Academy of Sciences).

Heinrich [1992]). This indicates that conflicts between government and enterprises have been less of a problem in Hungary, which has gone further than Poland in respecting the customary property rights of managers.

IV. The Case for Insider Privatization

The experience of Eastern Central Europe supports the proposition that large-scale, centrally organized mass privatization programs require a *strong state* [see also Poznanski, 1992]. Since they challenge the sources of rents of incumbent managers, workers, and bureaucrats, these kinds of programs usually face powerful resistance. Major output losses due to a long and unproductive struggle for control can be avoided only if the insiders can *quickly* be replaced by other effective owners, i.e., before they find the time to consume valuable productive resources, or if the enterprises can be kept under tight central control while further privatization is prepared.²³

In Russia and most other successor states of the Soviet Union, the central state is in an extremely weak position relative to the state-owned enterprises. Enterprise managers, bureaucrats in industrial ministries, and to some extent workers have acquired a substantial say in how “their” firms should be run and where profits, if any, should go. The major enforcement instrument of the old order, the communist party, no longer exists. Large parts of the central planning bureaucracy have been dismantled over the course of the reforms and would thus be unavailable for the task of supervising enterprises, should the state attempt to reestablish central control. But the major problem lies in the struggle between government and parliament [see also Hare et al., 1992]. Political reforms in Russia took place in several steps and are still far from complete. Both chambers of the Russian parliament are still remnants of communist times, and so is the constitution. As a result, enterprise insiders, who belong to the old *nomenklatura*, can use parliament as a platform for lobbying their interests. The startling rise of the industrial lobby in Russia in the second half of 1992, culminating in the replacement of acting Prime Minister Yegor Gaidar by the industrial manager Viktor Chernomyrdyn, testifies to the political clout of enterprise managers. The problem is compounded by the struggle between central and local authorities, which is far more pronounced than in the much smaller countries of Eastern Central Europe.²⁴ The authority of the center does not reach far enough to quickly enforce decisions opposed by regional and local bureaucracies and enterprises. This is why we would expect privatization programs that ignore the customary property rights of managers, workers, and bureaucrats associated with enterprises to run into problems of both enforcement and efficiency.

The crucial point is that attempts to reestablish central control, i.e., to expropriate the individuals who “own” the firms at the onset of the privatization program [Nayshul, 1992], are likely to provoke a struggle for control. In contrast to, for example, Czechoslovakia, the central authorities of Russia are so weak that this struggle would be very protracted and disruptive. In addition, the regional barter system, which is founded on personal relationships between the former lower-level *nomenklatura*, might break down in the process, depriving the economy of one of the few coordination mechanisms which are still working and which spare

²³ In the latter case, the state temporarily assumes the responsibilities of the owner after having stripped the incumbent *nomenklatura* of their customary rights.

²⁴ The overview of the legal basis of Russian privatization in Radygin and Krasnoselsky [1992] nicely illustrates this point in its effort to distinguish painstakingly between parliamentary laws, presidential decrees, decrees ratified by parliament, instructions issued by the Committee on Federal Property, programs adopted by the city of Moscow and so on.

Russia an even greater collapse in output. The obvious conclusion is that, in order to privatize its nominally state-owned enterprises quickly, Russia should respect and formalize the customary rights of insiders. In short: Russia should opt for insider privatization.

By insider privatization we will understand the transfer of ownership titles to, or their acquisition by, those groups of individuals who, prior to the reform, had been holding *de facto* rights to managing the enterprise, to disposing of (parts of) its profits, and sometimes even to transferring assets to other firms. These insiders can be managers, workers, and members of the old planning bureaucracy.²⁵ Generally speaking, insider privatization can take two very different forms. On the one hand, insider privatization can occur spontaneously — and often illegally — as the unintended by-product of attempts by still-socialist governments to decentralize the planning process or to allow complementary private activity outside the state sector [Kornai, 1990]. On the other hand, the state may adopt a privatization strategy that deliberately allocates a major proportion of *de jure* property rights to the insiders.

Spontaneous insider privatizations have occurred in Hungary and Poland in the last days of the old and the first days of the new regime. They have also been going on in Russia since 1990 [Filatochev, 1991; Johnson, 1991; Burawoy, Hendley, 1992; Hendley, 1992]. Examples of these unofficial privatizations include the opportunity for state enterprises to enter into cooperation agreements with foreign partners, to contract out some of their work to domestic private firms, or to allow workers to perform extra contractual work for the enterprise in their after-hours. These new opportunities were exploited by insiders who were motivated by the desire to secure their customary rights for the future and to exploit new sources of rents which happened to open up during the transformation process. In this way, privatization started from voluntary private initiative, even before it became official government policy.

The usual procedure is for the state-owned enterprise (SOE) to conclude an agreement with an outside partner (who frequently but not always is identical in person with the individual(s) running the state firm) on terms that are highly favorable to the latter. In Hungary, several cases made the headlines where managers had agreed to sell their state enterprises to foreign investors (sometimes of dubious reputation) for what were believed to be absurdly low prices. In return, these managers had been guaranteed a seat on the board of the new private firm that was thereby established. In a similar vein, some managers founded their own private companies and then transferred — against a token payment — to it the bulk of the movable assets of the state enterprise they were heading. The employees also moved on to the new firm, and the state enterprise was left behind as an empty shell with nothing but its debts remaining on its books. Winiecki [1992] reports similar cases from Poland. He relates instances where managers, apparatchiks, or their relatives founded a private company in order to obtain supply contracts from the state enterprise to which the insider was associated. The private company fulfilled these contracts by employing equipment and workers of the “parent” firm, often for a token fee. The prices charged to the state enterprise, however, were reportedly outrageously high. Although those are extreme examples, it is not too surprising that these kinds of activities provoked popular outrage in Hungary and Poland, resulting in an attempted crackdown by the central authorities. The Hungarian State Property Agency is the visible result of this backlash.

Given the potential for political controversies over insider privatization, we carefully need to consider the reasons that are advocated against this privatization method before we further advocate insider privatization as the most promising avenue for Russia. Eight major reasons are advanced for the rejection of insider privatization in general, and of its spontaneous, unofficial variant in particular:

²⁵ As has been shown above, the extent of these rights varies considerably between countries.

(1) *It is argued that the new private enterprises founded by way of spontaneous insider privatization tend to be even less efficient than the SOEs they emerged from [Winiecki, 1992].*

The reason advanced for this argument is that new firms created by members of the old nomenklatura just add the profit maximizing interest of their owners to the soft budget constraints of the old SOEs. The parent SOE grants to the private firm access to scarce resources on extremely favorable terms. Thus, the private firm does not allocate its inputs efficiently, and may not even be forced to minimize costs in order to be very profitable. The problem is compounded by the fact that the private firm often inherits from the state-owned parent a monopoly position in the market for its output.

The proposition can be based on two strands of arguments. On the one hand, the owners of the private firm, who usually are also the managers of the parent SOE, may be able to appropriate a larger share of profits and/or to pay higher wages than they could in the state-owned firm. This would give them the incentive to transfer profits to a nominally private firm while leaving costs for the state-owned parent to bear. Of course, this in itself does not *increase* the inefficiency with which production is carried out. However, the argument runs, the fact that they can appropriate a larger share of any income they may be able to generate for themselves will induce insiders to exploit the soft budget constraints of the parent enterprise even more recklessly than before. On the other hand, an increase in inefficiency could be explained by arguing that insiders may not be able to choose on efficiency grounds the assets which they want to employ in the new private firm. Rather, the choice of factor combination and scale of operation in the new firm may depend on which assets the particular insiders feel they can safely use without incurring the risk of intervention by the state or by other insiders in case there are conflicting groups within the same state enterprise. Thus, the new private spin-off might operate either on a more inefficient scale or with a more inefficient factor combination than the parent enterprise did.

The above arguments are not without merit in principle. A first-best sequencing would indeed require soft budget constraints to be hardened before state enterprises were granted the liberties they are enjoying *de facto* today. However, as central control has already lapsed in Russia, this has become a mute point. Of course, budget constraints for all Russian enterprises should be hardened as soon and as much as possible. First-best efficiency would also mandate an open bidding process to allocate ownership rights. However, with the Russian state as weak as it is, this option is not open at present either.

Most importantly though, inefficient choices of scale or factor combination, where they have occurred, resulted from the unofficial and often technically illegal nature of spontaneous privatizations. Insiders were constrained in their choices by a lack of secure property rights. The appropriate response to the above critique of spontaneous forms of insider privatization is thus not to reject insider privatization altogether, but to make insiders the primary beneficiaries of *official* privatization policy as well.

Apart from this, even the danger of spontaneous forms of insider privatization generally leading to worse performance is not as serious as it might seem. First, the effect of an increased tendency to exploit soft constraints might be countered by an increased tendency to respond to market signals in order to maximize profits. Second, the argument that spontaneous insider privatization leads to inefficient scales or factor combinations needs to be modified to the effect that it may lead to *different but not necessarily worse* scales and factor combinations. The gross inefficiencies prevailing in state-owned enterprises to begin with make it just as likely as not that the new way of production will be *more* rather than less efficient.²⁶

²⁶ Winiecki [1992] acknowledges that the efficiency problem is presumably not very serious. He maintains his criticism of spontaneous privatization on the grounds that it "gave a bad name" to privatization in general, thereby causing the delays observed in the Polish privatization process. The point is valid to the extent that spontaneous privatizations were carried out by managers over the heads of workers. Interpreted this way, Winiecki's argument is consistent with

(2) *Insider privatization is viewed as not conducive to hardening the enterprises' budget constraints because of leaving the old personal networks intact.*

However, the announcement that customary property rights will be largely recognized will contribute to bringing them out into the open, removing the secrecy with which the old elites traded in the administrative market. By opening up this market for outsiders, personal relationships will eventually lose in importance. The nomenklatura networks will give way to normal, more impersonal market relations. Indeed, the state could combine privatizations to insiders at very favorable conditions with a once-and-for-all withdrawal of discretionary subsidization.²⁷

(3) *Insider privatization is derogated as unfairly favoring the nomenklatura, i.e., the elites of the old regime. These old elites are seen as either retaining their dominant positions in the aftermath of the reforms or as enriching themselves [Blanchard, Layard, 1992], while popular sentiment has it that instead they should be held responsible for the crisis the countries are locked up in [see Filatochev et al., 1992].*

The first part of this argument criticizes the initial distribution of physical assets, while the second questions the resulting distribution of wealth. As to the former, the available evidence suggests that it is very difficult, even by inventing centrally-controlled privatization programs, to prevent members of the old nomenklatura from retaking strong positions in the emerging market economies [see also Hare et al., 1992]. It has turned out to be the rule rather than the exception in the transforming countries of Eastern Central Europe for enterprise representatives to retain substantial initiative and veto rights in the transformation process (see Chapter III). As for the criticism that insider privatization leads to an undesirable distribution of wealth, the weight of the argument again depends on the available alternatives. If it is true that insiders are in a position to delay ownership transfers to other groups, and if the uncertainty ensuing from this conflict induces them to consume part of the enterprise capital in the meantime rather than using it productively, society will be worse off under alternative scenarios.

(4) *Privatizing state enterprises is thought to have positive external effects for creating an environment that encourages further private investment [Roland, Verdier, 1992]²⁸ thus warranting active state involvement to speed up the process rather than just leaving everything to spontaneous forces.*

This consideration, however, strengthens rather than weakens the case for insider privatization in countries with a weak central government. Acknowledging the customary rights of insiders makes it easier to legally define and enforce property rights. If the central government is not sufficiently strong to overcome the resistance of insiders within a very short time, attempts to impose other privatization methods are likely to be largely futile, counterproductive, and time consuming. As has been pointed out above (Chapter III), the experiences of Eastern Central Europe corroborate this hypothesis.

Of course, the privatization of existing medium-sized and large enterprises by whichever method does not suffice to create favorable conditions for a surge in private investment activity. In order to overcome potential externality problems, it is at least as important to push small scale privatization. The experience from Eastern Central Europe since 1990²⁹ and the first experiences of success of major Russian cities since mid-1992 (notably Nizhny Novogorod, Moscow, and St. Petersburg) demonstrate that selling small retail and service

our proposition that it is the relevant insiders, i.e., in the Polish case the workers, who resist any kind of privatization which ignores their customary rights.

²⁷ I owe this point to Holger Schmieding. The problem would remain whether both parties to this agreement could credibly commit to sticking with it.

²⁸ These positive externalities could consist of better access to inputs and resources, better monitoring through relative performance evaluation, better diffusion of nonrival inputs, and lower costs of finding suitable partners for transactions in thicker markets.

²⁹ An overview of Polish small privatization can be found in Tamowicz et al. [1992].

businesses does not usually encounter the problems faced by privatizations of larger firms. The main reason is that privatization to the incumbent management or the employees does appear to be everybody's favored approach to small privatization. The scope for conflict is thus limited. Where there is conflict in individual cases, the stakes are not very high. There is neither much physical capital to be wasted, nor do the insiders have sufficient clout to either shape the drafting or influence the execution of official policy. Given the low priority of small-scale businesses in the socialist system, these insiders usually had been low on the hierarchy of the old regime. Thus, fairness considerations do not either stand in the way of giving small enterprises to their employees.

(5) Insider privatization is viewed as depriving the state, and society at large, of vital sources of revenue because either the privatization agreement does not foresee any payments to the state budget or the price which insiders are to pay is deemed too low.

This argument is considered especially important since the new governments frequently have to cope with macroeconomic instability fuelled by out-of-control budget deficits. With the tax system inadequate and tax collection unreliable, privatization revenues and/or revenues from profits of state enterprises are seen as crucial to the credibility of stabilization efforts [McKinnon, 1992]. However, the idea that the privatization of state enterprises could be a cure for state budget problems is an illusion. First and most obviously, any give-away scheme irrespective of the identity of the recipients will not create revenues. Second, in Czechoslovakia and Poland revenues have been insignificant, and the German privatization agency is piling up deficits. The only formerly socialist country which achieved anything close to sizable net revenues from privatization is Hungary. These revenues originate to around 80 percent from foreign investments [VWD-Osteuropa, a; Denton, 1992]. However, they would have to reach three times the amount actually forecast for 1992 in order to cover the projected budget deficit [VWD-Osteuropa, b; FAZ, a]. Therefore, privatization revenues can in no way be a substitute for tax reform, least of all in countries such as Russia which are not very attractive for foreign capital for the time being.

It is worth noting in this context that the future and, thus, the value of many medium-sized and large industrial enterprises in post-communist countries do not appear to be bright anyway. As the central planners had pushed these countries into overindustrialization, their industrial sectors are bound to shrink, notably in heavy industry. Furthermore, many oversized firms are likely to make way for smaller competitors. Many plants will require technological renewal, which changes them beyond recognition, because products produced with the present equipment are not competitive at the new relative prices (especially energy has become much more expensive). All in all, old state enterprises in the emerging market economies are unlikely to do better than new upstarts in an established market economy, which also have a high rate of failure: in the USA for instance, some 40 percent of new firms do not survive their first five years [Murrell, 1992b].

A peculiarity of Russia is that the central government at this point does not seem to be technically capable of securing most of the profit and income tax revenue due to it from still state-owned enterprises [DIW et al., 1992]. So not even on this count would insider privatization hurt the Russian budget very much. Put differently, the current shortfall of fiscal revenue from state enterprises indicates how customary property rights are actually distributed. In this sense, it is a consequence of the ongoing process of decentralization if not of de facto privatization.

(6) Insider privatization is also considered as inefficient because it allows those managers to hang on to their positions who had been selected under the communist regime not for their professional skills but for their political reliability [Pelikan, 1992; Frydman, Rapaczynski, 1992]. These managers are considered a liability for the new regime both because of alleged incompetence and because of potential leanings toward returning to the socialist system.

While managerial skills are certainly wanting in the old nomenklatura, they are also scarce among the rest of the population, and perhaps even more so. The people in charge of enterprises today are often individuals who actively pursued the chances opened up for them during the reforms of the old regime [Filatochev et al., 1992; Nayshul, 1992]. Under the Polish voluntary liquidation program and in Hungary, many incumbent managers are actively seeking cooperation with foreign partners and successful domestic entrepreneurs in order to compensate for their inexperience in a market environment.³⁰ The bottom line is that once their property rights are secure, insiders have incentives to improve the management of their assets. Should they not be capable of doing so themselves, owners can always trade their property rights or share them with more competent outsiders. It is important to realize that this possibility is available only if customary property rights are recognized. Indeed, the more these rights are being recognized officially, the more widely and more efficiently can they be traded. By contrast, if the state sets out to challenge their property rights, insiders have incentives to block privatization initiatives from outside.

(7) Insider privatization is believed to preserve the existing monopolistic structures and thus to prevent a new private sector from emerging.

It would undeniably be desirable to break up huge conglomerates for the sake of competition. Again, however, a weak state will be ill-suited to accomplish this feat against the opposition of powerful interests. Fortunately, first steps at splitting up Russian state enterprises de facto are occurring in a voluntary and spontaneous way [Burawoy, Hendley, 1992; Grigoriev, 1991; Filatochev, 1991; Malle, 1992] anyway. In 1988, it became legal for enterprises to have worker cooperatives within their departments. These cooperatives perform work for the enterprise on a contractual basis. They are a vehicle to withhold profits from the state. But they also introduce new market-like exchange relations into the enterprises. In-house competition for resources and for membership in profitable cooperatives is springing up. In addition, cooperatives take on the task of attracting business from outside and of marketing output. This *departmentalization* thus gradually erodes the self-sufficiency of Russian state enterprises, opens them up for new supply relations and increases their sensitivity to demand. Of course, introducing competition from the world market can be another way of mitigating the monopoly problem.³¹

(8) Insider privatization is said to lead to Yugoslav-style employee-owned firms, which are prone to grant excessive wages and neglect investment.

This problem may indeed be serious if ownership rights of employees are not transferable as was the case in former Yugoslavia. The problem largely vanishes if the property rights are transferable so that the holders of these rights have an incentive to care for the long-run expected profitability of the firm, which is reflected in the market price of these shares.

In Eastern Central Europe, there have indeed been reports of tendencies for insiders to organize former state enterprises in the form of *closed* joint stock companies [see Dabrowski et al., 1992; Lloyd, 1992]. The ensuing variants of worker management without transferability of shares to outsiders can be viable for small partnership-type firms only. In larger enterprises, moral hazard problems and inefficient capital intensity are known to arise [see, e.g., Alchian, Demsetz, 1972; Williamson, 1985]. The former problem is due to a lack of performance monitoring, the latter to the incentive to maximize the sum of wages and profits per worker. In addition, the allocation of risk tends to be inefficient. It is therefore important for the state to insist on open transferability of shares to be included in any company statute.

³⁰ For Poland, see Dabrowski et al. [1992].

³¹ At this point, the interdependence of microeconomic adjustment and macroeconomic stabilization becomes obvious: macroeconomic instability is fuelled by relying on the inflation tax to finance subsidies to unreformed state enterprises. In turn, macroeconomic imbalance causes the ruble to be grossly undervalued in real terms. And this undervaluation again insulates Russian state industry from the adjustment pressure of world market competition.

To sum up, the criticisms voiced against insider privatization are not convincing. The arguments are *either* related to insider privatizations forced into illegality by official policies that ignore customary rights, *or* to more general problems of the transition which no other privatization method could avoid given the circumstances, *or* they are less important than the problems which insider privatization serves to overcome. While some unofficial and illegal insider privatizations can indeed be dubious on grounds of economic efficiency (and certainly on legal and moral grounds), the arguments are not applicable to official insider privatizations. One qualification needs to be made though: the legal property rights which insiders acquire should be tradable; company statutes prohibiting the trading of shares to outsiders should not find the support of the state.

V. Lessons for Russia's Privatization Strategy

In early 1992, the Russian government drafted a detailed privatization program spelling out categories of state enterprises according to the priority with which they were to be privatized. The plan included a timetable differentiated by regions and specifying the percentage of state firms to be transformed in 1992. Revenue targets were also laid down [Delowoj Mir, 1992]. Later on, policymakers decided that the Russian transformation from plan to market should be made irreversible by privatizing thousands of state enterprises with the help of vouchers. Most of the firms with more than 1,000 employees or 50 million rubles book value are to be included. Roughly speaking, Russia's present approach to privatization combines elements of the voucher approach along the lines of the Czechoslovak example with elements of insider privatization.

The distribution of vouchers for a nominal fee began in October 1992. Like in former Czechoslovakia, the relevant laws call for the mandatory commercialization of several thousand state and municipal enterprises to be included in this scheme. These enterprises are to be transformed into open joint stock companies. The shares of these companies will be owned initially by the All-Russian Property Fund and its regional subsidiaries. In order to work out the details of the privatization procedures, a State Committee on Property has been created. Unlike their Czechoslovak counterparts, Russian vouchers are bearer securities, i.e., they are tradable for cash. A secondary market is developing.³²

The Russian privatization program allows firms to choose from a number of alternatives. The first alternative grants managers and workers access to up to 51 percent of shares for vouchers or for cash at a favorable price, usually 1.7 times the book value of the respective share in the firm's capital as calculated in January 1992. There are two other alternatives. Under the first, employees and retirees get nonvoting shares in the amount of up to 25 percent of the enterprise's capital free of charge. They can acquire up to another 10 percent of the capital in the form of voting shares, either for cash at a 30 percent discount on the face value or for vouchers at face value. Managers can buy up to 5 percent of the shares at face value. Under the second alternative, employees get up to 20 percent of the voting shares at face value, with another 20 percent going free of charge to a group of managers and workers willing to take on the restructuring of the company [see

³² Opinions on the eventual equilibrium price of the vouchers vary wildly. Anatoli Chubais, the head of the Federal Property Committee, claims that their nominal value will be substantially higher than their face value of 10,000 rubles because this face value had been calculated from the book values of firms at the end of 1991. Others, however, are far less optimistic [see Radygin, Krasnoselsky, 1992]. In recent months, 4,000 and 7,000 rubles were the prices quoted for vouchers in newspaper reports. Of course, if Russian inflation continues at monthly rates of 20 to 55 percent, the nominal price for vouchers may easily surpass 10,000 rubles even if the real value of the vouchers declines.

Delowoj Mir, 1992]. The rest of the shares goes to open auctions.³³ Overall, a maximum of 80 percent of the share capital in federal enterprises can be bought with vouchers. In municipal and regional enterprises the figure is 35–45 percent [Radygin, Krasnoselsky, 1992]. The Russian privatization program demands that the open transferability of shares should be incorporated in the statutes of all companies included in the program.

Like many other post-socialist privatization schemes, the Russian variant of voucher privatization scheme is supposed to achieve three goals:

- *political*: to make the reforms irreversible and to forge support for the government;
- *social*: to create a broad class of new owners and to let the population at large share in an equitable way in the property which had originally been financed from its savings;
- *economic*: to improve the efficiency with which the enterprises are being run and to facilitate the reallocation of assets.

The strong reliance on vouchers is seen as a major instrument to accomplish these goals. However, whether the Russian mass privatization scheme in general and its voucher element in particular can actually serve these purposes remains open to serious doubts.

As to the *political goal*, the voucher approach will strengthen the government's popularity only if it is successful in the sense of giving to the population truly valuable assets. Unfortunately, this may not be the case. There have been reports of local and regional authorities teaming up with managers to keep the profitable firms out of the program [Lloyd, 1992; Ziesemer, 1992]. Should a large number of firms that are included in the program, and with them investment funds, prove unprofitable, popular support might quickly turn into dangerous disappointment. Neither will the scheme necessarily make ownership changes irreversible. Precisely because it is investing a lot of its remaining prestige in the voucher scheme, the government may prefer to bail out ailing firms or funds and to take them over again, rather than allowing a wave of bankruptcies to follow the wave of privatizations.³⁴

As to the *social goal*, the initial distribution of vouchers will not determine the eventual structure of ownership of productive assets [Schmieding, 1991]. The scheme is unlikely to turn the population into entrepreneurs overnight. Many citizens will probably cash in on their vouchers as soon as possible.³⁵ And those people who actually participate in share auctions will not end up with portfolios of roughly equal value because the values of individual assets are likely to change considerably in the immediate aftermath of privatization.

As to the *economic goal* of voucher privatization, an improvement of the performance of enterprises can be expected from a change in ownership only if it leads to a more unambiguous definition and more stringent enforcement of property rights than before and if the new owners are more able and willing to impose profitability as the firm's dominant goal.³⁶ It is still too early to see whether the Czechoslovak system does

³³ According to a preliminary report, 5,600 of the 6,000 firms to be included initially in the privatization program complied with the obligation to state their preference for one of the different privatization methods by 1 November 1992. Roughly half of the firms opted for the first variant [The Economist, b].

³⁴ This is what happened in the early 1980s in Chile where the extra liquidity that was deemed necessary for privatization was provided not by vouchers but by government-subsidized credit [see Nankani, 1988; Agarwal, Nunnenkamp, 1992].

³⁵ Due to individual differences in attitudes toward risk, it would be inefficient to force citizens into becoming entrepreneurs. Thus, it is the goal of egalitarian distribution of productive assets that is to be criticized rather than a method which fails to achieve it. Indeed, their convertibility into cash is one of the advantages of the Russian vouchers over their Czechoslovak namesakes.

³⁶ For an exposition of goal multiplicity as the source of inefficiency in publicly owned enterprises, see Hartley and Parker [1991].

accomplish this change. Czechoslovak firms have come to be dominated by investment funds which might choose to behave like their counterparts in developed market economies: to passively manage portfolios rather than to actively restructure firms, and to free ride on attempts at takeovers.³⁷ Also, some of the largest funds in former Czechoslovakia have been set up by *state-owned* financial institutions. As a consequence, enterprises “privatized” to these funds have not really left the state sector. It will therefore take time before firms find active owners and market-oriented restructuring actually begins. But all this assumes that the Russian voucher scheme will work as smoothly as the Czechoslovak variant did. This, however, is by no means guaranteed. To the contrary, the weakness of the Russian central authorities relative to their enterprises gives insiders the chance to obstruct the implementation of the program in an attempt to appropriate more rents than the state is willing to grant them.

Russia’s strong emphasis on the voucher element of privatization can even impair the chances for a successful implementation of the privatization program. Unlike some other forms of privatization, notably a partial sale of ownership rights to active external investors, voucher privatization does not augment the capital base of the firm. Enterprise insiders have more reason to object to a distribution of property rights to the local population via vouchers than to a partial sale to external investors which enhances the capital base as well as the potential profitability of the firm and which often happens on terms that have been influenced by the respective firms. The comparatively satisfactory performance of such privatizations involving outside investors in Poland and the preference of Czechoslovak managers for this privatization method corroborate this hypothesis [see Dabrowski et al., 1992; Heinrich, 1992].

The Russian privatization program attempts to defuse the potential resistance of managers, workers, and local bureaucrats in two major ways: (1) The privatization proceeds that will accrue to the public purse under the program are largely allocated to local and regional authorities. According to the draft of the privatization program for 1993, local and regional authorities will often get 100 percent of these proceeds, with the central government claiming 35 percent of the proceeds only in the case of some supposedly strategic industries such as the defence and energy industries. (2) The privatization program allows for more insider participation than is the case, for example, in Czechoslovakia.

But, given the fact that the program asks enterprises to hand over the rights to a minimum of 49 percent of assets and future profits³⁸ to outsiders, considerable resistance must still be expected. To be sure, insiders do get something in return: the official recognition and protection of their property rights by the state. However, it remains open to serious doubt whether this support by the weak Russian central state is worth this high a price for the insiders. The equilibrium price of government protection might be closer to the 35 percent of the cash revenues from share auctions which the central government claimed for itself in the few pilot cases of mass privatization in late 1992 (this is equivalent to 7 percent of the overall share capital in the case of enterprises to be disbursed to 80 percent for vouchers). Whereas a limited degree of voucher privatization may be easily acceptable to the enterprise insiders as a device to promote popular acceptance of an insider-dominated privatization method, the heavy emphasis of Russia’s present privatization program on vouchers may well go

³⁷ For an overview of the role of institutional investors in market economies, see, e.g., The Economist [a]. The problem of a passive attitude of large institutional investors is addressed, e.g., in Committee on the Financial Aspects of Corporate Governance [1992]. For conditions under which the free rider problem may be a serious problem in Eastern Europe, see Frydman and Rapaczynski [1991a].

³⁸ Insiders may participate in open auctions to acquire additional shares of their own enterprise, but in this case they are being forced to pay the same price as everybody else for something which they consider their property anyway. The only way to rationalize limits on the preferential allocation of shares to insiders would be to interpret the issue of shares to outsiders as a payment for popular acceptance of privatization.

to far. In its present form, Russian mass privatization still runs the risk of aggravating the current economic crisis without reaching the political and social goals in the end.

Of course, all arguments about the effective resistance of insiders against Russia's privatization approach are speculative in nature. However, one should bear in mind that the stakes in Russian privatization are particularly high. Having abandoned the initial (and ill-executed) quest for macroeconomic stabilization in mid-1992 under the pressure of the emerging industrial lobby [DIW et al., 1992], Russia's reformers have invested most of their remaining prestige and political clout into the privatization program. Given the economic and political importance of a smooth implementation of a mass privatization program in Russia, it thus appears prudent for the central government to minimize the hazard of insider resistance by increasing the element of insider privatization at the expense of the economically dubious element of voucher privatization. Seen from this angle, there appears to be too little rather than too much insider involvement in the Russian privatization process to date.³⁹

All in all, in order to promote a rapid growth of the private sector in Russia, the central government should thus proceed as follows:

- It should concentrate its efforts on creating favorable conditions for the development of new private activity [Murrell, 1992a; Schmieding, 1991; see also Ickes, Ryterman, 1992] by removing barriers to market entry. To this effect, land and office space should be made available for private business. In order to improve the mobility of capital between firms and sectors [Hinds, 1990], bankruptcy legislation should be completed and enforced.⁴⁰ Rational capital allocation should be supported by reforming the banking sector [Schmieding, Buch, 1992].
- As far as the privatization of existing enterprises is concerned, the focus should be on small privatization.
- In the voucher program, the preferential access to insiders should be expanded while the importance of vouchers should be scaled down. For this purpose, the Russian central government need not revoke its present privatization approach. Russia's local and regional authorities are largely *de jure* (and even more so *de facto*) in charge of the implementation of the privatization policy anyway. It would suffice for the central authorities to grant the regional and local authorities the right to deviate substantially from the centrally fixed limits on the preferential conditions for insiders at their own initiative. Even if the voucher element in the mass privatization program is reduced, the vouchers, which have already been issued, could still be useful if a sufficient number of small businesses, land, and flats were to be sold for vouchers.
- Other than that, privatization agreements reached jointly by the groups who hold the customary property rights in an enterprise (managers, workers, local bureaucrats, possibly even lenders and suppliers) should be legally recognized and protected, even if the central laws should be silent on the privatization methods employed. Indeed, there is no reason why different regions and even individual

³⁹ For Poland, Sachs [1992] now concedes that insider privatization has been used too little and that the crackdown on spontaneous privatization was an overreaction.

⁴⁰ Of course, this legislation will also meet with resistance from industrial lobbies. But the obstacle may be easier to overcome because bankruptcy does not pose a universal threat to the property rights of all enterprise insiders simultaneously (there will be some enterprises who welcome the chance to collect some of their overdue receivables). For the current state of Russian bankruptcy legislation, see Radygin and Krasnoselsky [1992].

enterprises should not try different approaches. Those approaches which prove successful could then be adopted on a wider scale.⁴¹

VI. Conclusions

Privatization from below is making good progress in Eastern Central Europe, particularly in Hungary and Poland [Grabowski, Kulawczuk, 1992]. The same is true for small privatization where capital requirements and internal control problems are few. Small firms, who tend to be rather close to their market and relatively flexible in their organizational structure, can therefore adapt rather easily to changing environments.⁴² The privatization of large state enterprises is proving much more difficult. Differences in initial conditions are reflected in different strategies and speeds of privatization.⁴³

Unofficial insider privatizations have been opposed in Poland and Hungary for both fairness and efficiency reasons. However, the alternative methods introduced in these countries do not generally perform better in the domain of social and political justice as defined by opponents of this spontaneous kind of privatization. The most successful official privatization methods in Hungary and Poland are those reserving a substantial say for insiders, particularly buy-out method. The fact that Hungary has been able to privatize much more quickly than Poland is attributable inter alia to Poland's attempt to preserve many of its best performing companies so that they could be included in the mass privatization program which has been caught up in political infighting over the distribution of property rights. In the meantime, adjustment efforts in the companies have ground almost to a halt, and managers and workers have been busy appropriating (parts of) the companies' wealth.

Unofficial spontaneous insider privatizations are currently going on in Russia. These are both a result and a cause of the continuing disintegration of the old order. The privatization program of the central government attempts to reduce the influence of insiders, it claims to speed up the transformation process, and it intends to create a broad class of capital owners. In light of the experience from Eastern Central Europe these hopes may well be frustrated, mainly because the Russian central authorities lack the political strength and bureaucratic muscle to quickly decide in their favor the ensuing struggle with the powerful local nomenklatura and enterprise managers. Still worse, this conflict may greatly increase the uncertainty faced by insiders and potential outside investors. The result would be more myopic behavior of insiders, less efforts at adjusting to new economic conditions, and a further decline of economic performance.

Although Russia's official privatization program gives local bureaucrats as well as managers and workers a greater say in the privatization process than the programs of Eastern Central Europe, it would be prudent for Russia to enhance the role for insiders even further. Officially recognizing customary property rights would make these rights more openly tradable and would minimize the scope for conflict. This approach does not require a strong, well-organized state. It thus economizes on one of the scarcest resources in Russia today [Nayshul, 1992].⁴⁴ A considerable dose of official insider privatization appears to be the best available method to make sure that productive assets get into the hands of the best qualified owners quickly.

⁴¹ Hendley [1992] reports how managers and workers of a large state enterprise transform their company on their own, relying on Western blueprints to fill gaps in the existing Russian legislation on corporate statutes.

⁴² For the role of cognitive constraints, routines and learning in the adjustment of existing organizations to external shocks, see Murrell [1992a] and Swaan and Lissowska [1992b].

⁴³ Frydman and Rapaczynski [1991a] explain how bounded rationality leads to path-dependent behavior in the transition.

⁴⁴ A similar point is made in Frydman and Rapaczynski [1991b].

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