Reforming the Reform Process: Privatization in Central and Eastern Europe

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REFORMING THE REFORM PROCESS: A CRITIQUE OF PROPOSALS FOR PRIVATIZATION IN CENTRAL AND EASTERN EUROPE*

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I. Introduction

As communist regimes throughout Central and Eastern Europe have fallen one by one under the weight of economic failure and popular discontent, the task of transforming these countries into stable and vibrant liberal democratic societies has commanded the attention of many Western governments and international organizations. Given the rapid and extremely destabilizing deterioration in the levels of production and employment in each of the Newly Liberalizing Economies (NLCs), economic renewal has become an urgent priority of the transformation process. Initially, the greatest importance was attached to reforms involving stabilization and liberalization of prices, lowering of trade barriers, fiscal restraint, and currency convertibility. Nevertheless, at a relatively early point in the reform enterprise, it became strikingly apparent that extensive micro-economic reforms would also be necessary for the transformation pro-

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cess to succeed. At the core of these micro-economic reforms stands privatization—the policy aimed at "reducing the role of government, or increasing the role of the private sector, in an activity or in the ownership of assets." However, unlike the relatively straight-forward adoption of many of the measures aimed at macro-economic reform, the pace of privatization programs in the NLCs, as measured by the amount of existing assets transferred from the state to the private sector, has been extremely disappointing. In Czechoslovakia, Hungary, and Poland, for instance, there have been very few large-scale privatizations, although recently there have been some impressive results obtained with respect to small-scale privatization.

In attempting to identify the sources of delay in the process, Western commentators have attributed the lion’s share of responsibility to policy-makers in the NLCs. This line of attack implicitly assumes that the programs devised by Western policy analysts (largely economists) are fundamentally sound, and that it is only the lack of commitment to, or intellectual appreciation of, the rather unassailable case for radical privatization policies that has impeded successful policy implementation. If this assessment is accurate, then the possibilities for hastening the pace of privatization programs are extremely limited.

In this article, we advance a rather different explanation for the debilitating delays and uncertainty that have plagued privatization in Central and Eastern Europe. Instead of focusing on implementation difficulties, we argue that the source of the faltering pace of privatization in the NLCs lies within the basic architecture of the programs themselves.


3. In Poland, for instance, by the end of June 1991, only 13 out of a total of more than 7000 state enterprises had been sold. Steve Lohr, Poland to Privatize Industry by Giving Stakes to All Adults, N.Y. TIMES, June 28, 1991, at A1. However, small-scale privatization of shops and services has been significantly more successful. As of February 1992, 70% of retail outlets in Poland were privately owned. The Business Outlook: Poland, Bus. E. EUR., Feb. 10, 1992, at 64.
Specifically, we believe, with some notable exceptions, that most of the large-scale privatization plans are beset by severe conceptual confusion going to the very purpose of the privatization enterprise.

This confusion reflects, to a large extent, the loading of privatization plans with numerous and often conflicting goals. Contrary to the initial intent of many Western advisers, the privatization programs devised for the NLCs, have strayed well beyond the preserve of efficiency to include such conflicting goals as government wealth creation, dissipation of concentrated political power, and compensatory justice. Recognition of the existence of multiple goals in the privatization enterprise leads directly to the question of which instruments are best suited to the realization of these goals. One way to rectify the haphazard progress of privatization in the NLCs is to “unbundle” policy by remitting certain privatization goals to other, more finely honed, public policy instruments.

Although determining how privatization policy became loaded with so many diverse and irreconcilable objectives in the first place, is an exercise fraught with considerable complexity we speculate that at least part of the reason for its peculiar evolution emanates from an insensitivity to the interaction between economic and non-economic values that has become enshrined in privatization policy. This insensitivity, in turn, reflects a fundamental misreading of the meaning of the revolutions that marked the end of communism in Central and Eastern Europe. In much of the academic and popular writing on privatization in the NLCs, there is an assumption that popular revolutions throughout Central and Eastern Europe have marked an unalloyed triumph for free markets and weak states, as defined according to classical conceptions of liberal capitalism. Nevertheless, we argue that it was the notion of a more humane and workable version of the modern liberal welfare state, as found throughout Western Europe and North America, that really inspired change in Central and Eastern Europe. The liberal welfare state’s attractiveness to citizens in Central and Eastern Europe is understood when one considers its proven

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ability to achieve the economic goals of socialism (working class prosperity, high levels of employment, relative economic stability, and social security) under conditions of freedom and democracy.\textsuperscript{5} It is among the greatest ironies of intellectual history that the attack on laissez-faire by the Western left laid the ideological ground for the modern social welfare state, which minimized the allure of communism in the West and provided an attractive alternative model to the East. This modern social welfare state proved that capitalism need not be as harsh and unstable as Marx had imagined.

Inordinate focus on planning the removal of the state from direct economic activity has had important ramifications for policy development. It has diverted attention from the task of crafting new effective policy levers and institutional arrangements whereby the state can manage the economy, forge legitimate deals between social and economic interest groups, and adequately control the instability and resurgence of societal cleavages. Even if it were possible, massive privatization without the prior or simultaneous creation of strong and legitimate public institutions and new social contracts would be decidedly dangerous for political and social stability. Indeed, much of the hesitancy towards moving more rapidly with privatization-oriented reforms, which Western observers tend to interpret as a wavering allegiance to markets or a misunderstanding of them, stems from such concerns. Instead of reacting with disappointment to, or alarm at, the slow pace of privatization in Central and Eastern Europe, Western advisers should focus more attention on the strengthening of public institutions and the creation of appropriate levers of economic management.

II. THE OBJECTIVES OF PRIVATIZATION

Close inspection of the privatization programs adopted in Central and Eastern Europe reveals the presence of multiple policy goals. Although varying in the degree of emphasis given different objectives, most privatization programs in the NLCs have pursued some, if not all, of the following goals: (i) wealth maximization; (ii) enhancement of government revenue.

enue; (iii) decentralization and fragmentation of political power; and (iv) vindication of compensatory justice concerns. In this section, we consider the nature of the privatization program that exclusively pursues each of these goals. This exercise reveals in rather stark terms the depth of the conflicts that are created when all of these goals are compressed into a single program. Despite the premium we place on policy unbundling, i.e. remitting different goals to different instruments, we do find that some goals can be accommodated within the same privatization program, and we suggest ways in which the friction created by simultaneous pursuit of these goals can be reduced.

A. Global Wealth Maximization

As discussed above, policy analysts most frequently invoke the goal of global wealth maximization (or efficiency) in the design and implementation of privatization programs in the NLCs. The efficiency case for privatization hinges upon assumptions about differences in the incentives that weigh upon private, as opposed to public, actors with respect to the management of enterprises. If one begins from the proposition that under conditions of perfect competition, and absent other market imperfections, self-interested market exchanges will result in allocation of scarce productive resources to highest valued uses, ownership of the means of production by economically self-interested actors seems a logical means of achieving the maximization of aggregate economic wealth. This is the essence of Smith's invisible hand. 6

This insight does not depend on a simplistic identification of aggregate economic wealth with optimum social welfare. Rather, the assumption is that these are separable, well-defined concepts, and where these two diverge the appropriate response is not direct public management of production, but various forms of regulation and taxation that influence or constrain the decisions of private managers, who remain motivated entirely by profit maximization. 7 This assumption is not uncontroversial, however, as evidenced by

7. JOHN VICKERS & GEORGE YARROW, PRIVATIZATION: AN ECONOMIC
the vigorous debate in North American corporate law theory as to whether the background legal rules and basic expectations with respect to managerial behavior should reflect a general notion of broader social responsibility, permitting or even encouraging managerial decisions that diverge from the requirements of profit-maximization. 8

In theory, of course, even though government has a much wider variety of goals to achieve than wealth maximization, it could run an enterprise with a view to this goal alone. Indeed, Laux and Molot have suggested that in a number of Western countries there has been a move towards instructing public managers to run enterprises on a profit-maximization basis. 9 In practice, however, governments are accountable to diverse public constituencies for the decisions they make in the management of public enterprises, and the goals and interests of many of the most powerful of these constituencies may be at variance with the demands of profit-maximization. As a consequence, governments are often forced to back away from an unqualified commitment to profit-maximization in the delivery of public goods.

The problems for governments in containing demands of special interest groups in favor of an unadorned profit-maximization calculus are illustrated, in particularly dramatic terms, by some of the failed experiments in enterprise-management that were aimed at restoring some semblance of profit motivation in Central and Eastern Europe. As Hinds has observed, the flirtation of communist governments in Hungary, Poland, and Yugoslavia with these schemes inevitably ended up with managers and employees conspiring to increase their wages and job security by going on extensive inter-firm borrowing binges and by foregoing needed investment in obsolete plants and equipment. 10 Of course, these problems are not confined to the East. Governments in the

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10. HINDS, supra note 1, at 10-43. These problems are not, of course, confined to the East.
West often yield to the demands for protectionism by public sector management and labor groups despite the dire efficiency consequences and questionable non-efficiency rationales for policies that resist rather than ease the adjustment to change.\textsuperscript{11}

Even if it is assumed that government officials have a desire to deliver goods and services in a way that is disciplined by profit-maximization objectives, and, further, that they are able to keep special interest groups at bay, a strong presumption operates that the capacity of public management to effectively vindicate these goals will, for the most part, be deficient in relation to the private sector. This comparative disadvantage emanates mainly from the distorted incentives for efficient risk-taking that are pervasive within the bureaucracy. Whereas private entrepreneurs (in a setting characterized by trivial agency costs of equity) will bear the full residual financial consequences of a given project (either losses or profits),\textsuperscript{12} public officials responsible for hiring and firing managers of public enterprises, and for giving them broad policy guidance, have only an indirect stake in the success or failure of the enterprises in question. While it is possible that internal promotions or demotions may make bureaucrat welfare somewhat sensitive to the relative success or failure of a proposed project, such settling-up mechanisms only partially capture the intensity of penalties and rewards that private sector owners will face from the same investment project.

The fact that public officials face a different set of penalties and rewards will, not surprisingly, exert an important impact on the nature of their decision-making. Under the positive net present value rule used to evaluate investment decisions in the private sector, projects are selected on the basis of the magnitude of their relative economic value.\textsuperscript{13} The larger the positive difference between the benefits of a

\textsuperscript{11}See Michael J. Trebilcock et al., Trade and Transitions: A Comparative Analysis of Adjustment Policies, chs. 1, 6 (1990).

\textsuperscript{12}Of course, limited liability and bankruptcy law provide a legal framework for sharing or mitigating the risks of financial loss inherent in any business venture, as do labor laws that allow relatively rapid and inexpensive dismissal of workers.

\textsuperscript{13}Richard A. Brealey & Stewart Myers, Principles of Corporate Finance, ch. 2 (2d ed. 1984).
given project (as measured by the sum of the range of possible expected future financial outcomes) and the costs (as measured by market parameters), the more attractive the project is for selection. Most importantly, the rule bars the selection of projects characterized by negative net present values. Within the public sector, the positive net present value rule, and the principles of risk and return that undergird it, will have less force. As a consequence, public sector decision-makers can be expected to allocate and utilize resources less efficiently than in the private sector.

Finally, public sector decision-making may be less conducive to the efficient allocation of production factors due to the dearth of effective external constraints on public sector conduct. Whereas the resource allocation decisions in the private sector are subject to searching and unrelenting external review by a wide range of markets, including the capital, product, labor, and, in some cases, takeover markets, public sector decisions are constrained by a much weaker and more episodic system of scrutiny involving specialized agencies (e.g., the auditor general), as well as infrequent voting by citizens in elections. Divergences in both the intensity and duration of project review mean that public sector decisions are prone to more serious errors at the project valuation stage. Without the discipline of the marketplace, public sector decision-makers will have less robust data upon which to make decisions. It is also likely that these problems will continue well past the formation stage of public programs as decision-makers become wedded to non-market initiatives. These problems are particularly severe when, as in the case of the NLCs, the scope for market review has been completely usurped by the state, depriving markets of any checking role. Moreover, even where public officials do at-

14. Clearly, however, major state-owned enterprises in Western countries (e.g., Renault in France) are subject to scrutiny by market analysts, if only because they have private sector competitors. By contrast, the problem is most severe where the public enterprise is also a monopoly, as is the case for much of Eastern Europe.

15. Some public enterprises raise funds in the private debt capital markets, which has the effect of subjecting their decisions to external scrutiny imposed by lenders in those markets.

16. This argument should not be construed as a claim that private managers never blunder, but rather when they do, market mechanisms are
tempt to hire and fire managers on the basis of their capacity to maximize profits, the absence of a functioning market for managers and the lack of good information about their relative profit-maximizing capabilities make this exercise highly problematic in the Central and East European context.

The efficiency claim in favor of private markets should not, however, be taken to mean that this mode of allocation will always produce wealth maximizing outcomes. Commencing with Berle and Means,17 numerous American scholars belonging to the "managerialist school" have cast doubt on the willingness of managers to subordinate their own interests to the overriding goal of shareholder profit-maximization. This sentiment is evidenced by the underlying vigor of market mechanisms. Although law and economics scholars have refined many of the managerialist claims by insisting that claims of managerial opportunism be grounded in some evidence of external market or internal governance failure, the fact remains that even these scholars would agree that private managers may deviate from an unwavering commitment to profit-maximization.18 Hence, before concluding that the private sector is better able to vindicate efficiency goals across all contexts, it is necessary to compare the magnitude of the wealth losses from internal agency costs occasioned by private and public delivery. Generally, however, where objectives can be precisely specified and conduct designed to achieve those objectives can be easily monitored, private production will be superior to public produc-

more effective in meting out appropriate penalties by either barring further recourse to capital, or, in extreme, by reallocating assets through bankruptcy proceedings. Of course, in theory, governments could let non-viable public enterprises fail in this manner. In practice, however, political pressure ensures that they almost never do.

18. Indeed, the convergence between these two bodies of scholarship is underscored by the legal economist's focus on controlling costs occasioned by shirking and perquisite consumption. For a review of the relationship between managerialist and law and economics scholarship, see J.S. ZIEGEL ET AL., CASES AND MATERIALS ON PARTNERSHIPS AND CANADIAN BUSINESS CORPORATIONS 367-80 (2d ed. 1989).
Given the advantages of private sector organization in effectuating wealth maximizing conduct, what are the implications for privatization initiatives in the NLCs? It is an essential starting point for the creation of an environment conducive to wealth maximization that productive resources be capable of allocation through voluntary exchange. Therefore, resources must take the form of property that can be alienated. Under the old regime, lawful possession of assets was based upon administrative order or fiat. Although there has been considerable inter-enterprise “trade,” especially after the first wave of decentralizing reforms in most of the Central and Eastern European countries, it has been based upon detailed administrative guidelines and practices. Additionally, even though enterprises, and their workers and managers, had various legally prescribed rights, duties, and privileges, no one actually had a proprietary claim on the assets of the enterprises—not even the state. The move towards greater management control of state assets engendered by the decentralizing reforms has created one of the great ironies of the current privatization process. In order for the state to effectively privatize these assets through divestiture, the state must first centralize its control over them.

Proprietization does not, of itself, imply privatization, and indeed its first stage has generally been the establishment of industrial assets as property of the state. However, this form of proprietization has not been without its controversial dimensions. Workers and managers have often claimed that rights to manage and share in the revenues of enterprises that were granted under socialist economic reform have the character of quasi-proprietary entitlements, and hence that proprietization by the state is a kind of taking.

21. As Hinds, supra note 1, at 21, has stated: “In effect, having socialist enterprises owning themselves means that nobody owns them.”
This provides some degree of justification, perhaps, for the propensity of workers and managers to "spontaneously privatize" property in the first stages of the post-revolutionary period. Does privatization guided by wealth creation require that the state be the recipient of newly created property rights? Wealth creation does not require that the state be the first, albeit interim, owner of newly created property. However, there are sound reasons for supporting this role. First, the state would appear to be more sensitive than those individuals involved in spontaneous privatizations to the need for preservation of the "going concern" value of enterprises. Second, the attractiveness of the state as initial interim owner is buttressed by the fact that it is the institution best situated to determine the appropriate scope of privatization of state assets. Third, recognizing that the state must retain at least some assets so that it is able to fulfill its end of the bargain under the social contract, it seems appropriate that the state initially retain ownership and then dispose of its inventory of assets as the extent of its obligation and the degree of property necessary to fulfill this obligation become more clear. A final reason for interim state ownership emanates from the necessity of state action in readying assets for transfer to the private sector by, among other things, negating debt obligations that were incurred by enterprises during predecessor communist regimes. Because these obligations were incurred in a setting where capital budgeting decisions were largely impervious to consumer demand, there may not be any continuing economic rationale for these obligations to be enforced in a market context. It should be noted that interim state ownership could be combined with manage-

23. These privatizations involved hastily concluded alliances between the nomenklatura and other stakeholders (e.g., worker councils and foreign investors) that enabled the privatizers to make quick profits on the sales of assets of state run factories. For a discussion of spontaneous privatization, see Janos Kornai, The Road to a Free Economy: Shifting From a Socialist System: The Example of Hungary 80-93 (1990). See also id.

24. In particular, in the carnival environment of rapid asset sales, the prospects of promoters squandering scarce going concern value in an effort to obtain quick profits are enhanced.

25. See Olivier J. Blanchard et al., Reform in Eastern Europe 49 (1991). Hinds, supra note 1, at 74-78, also argues for negation of outstanding loan obligations prior to privatization, but only to the degree
ment contracts, where private managers or consulting firms oversee the day-to-day running of enterprises in the interim period. Perhaps a central reason why this course of action has not been recommended or taken in most cases is the expectation that privatization itself can be achieved very rapidly. Accepting that this expectation is unrealistic (as argued in this article) would perhaps have the salutary effect of drawing more attention to the issues surrounding interim oversight of state enterprises. The quality of such interim oversight may well be decisive in preventing the stripping of assets or other “end game” behavior by workers and management, and more generally, in preserving or enhancing the ultimate value of the assets to be sold into private hands.

In considering how newly minted property entitlements should be distributed, or indeed, who should be the ultimate recipient of these entitlements, a privatization scheme based on wealth maximization requires only that entitlements be distributed in a way which maximizes the likelihood that the property will gravitate to the highest valued user. This means that an efficiency motivated privatization scheme would not concern itself with the fact that undesirable entities, such as foreign investors, former members of the nomenklatura, or black marketeers were the most efficient users of the property. In other words, to deny highest valued users distributed property requires the invocation of norms that are based on considerations quite distinct from efficiency.

Following Coase, another important consideration to bear in mind when considering the initial distribution of property rights is the efficiency of secondary trading markets. The greater the confidence of planners in the capacity of markets to re-allocate property received under the initial allocation—at relatively low cost—the less the importance of whether or not the initial recipient is, from an efficiency perspective, the highest valued user. Simply put, necessary to induce new owners to make long-term investments in the enterprise.

28. Given, however, the fact that the initial recipient of the property will receive some consideration for the property when it is traded in the secondary market, the issue of initial distribution becomes very important
the question is whether the transaction and administrative costs in designing a privatization scheme to maximize the efficiency of an initial allocation are higher or lower than those entailed in subsequent reallocation to higher valued uses. Since changing market conditions, domestic and international, will make even the most perfect initial allocation unsatisfactory after a period of time, there is a strong argument—given the scarce resources available to the policy reform process—for concentrating on the development of low-transaction-cost mechanisms for market re-allocation. The focus of the initial allocation decision then becomes the various non-efficiency goals, such as compensatory justice.

Predictably, the decision as to which route to follow in efficiency-inspired privatizations depends on a complex and highly country-specific cost-benefit analysis. Included in the calculus of choice are such factors as: (i) the political and ethical import of the non-efficiency objectives to be vindicated in the initial distribution; (ii) the possibilities of disentangling the realization of these goals from the distribution of in species property; (iii) the comparative administrative costs of each regime; and (iv) the time required for each regime to be implemented, bearing in mind Lipton's and Sachs's concern with the potential for privatization delays to subvert the entire reform effort. 29

Although the choice between these two approaches is one that must ultimately be remitted to the political realm, thereby underscoring the salience of our earlier claim in favor of strong, legitimate states, we offer some general thoughts on the design issues necessary to implement either approach. If governments opt for a regime in which effi-


Both the economic logic and the political situation argue for a rapid and comprehensive process of transition... [P]robably the greatest political risk facing Eastern Europe is not a resurgence of communism, but the Argentine trap of political and social paralysis, in which coalitions of workers, managers, and bureaucrats in the declining sectors succeed in frustrating the needed adjustments.

Id. at 99-100.
ciency is to be promoted at the secondary trading stage, then there is some urgency that stable, adequate rules for market reallocation be implemented. Following the logic of Coasian analysis, these rules should, as far as possible, lead to the types of agreements that would be arrived at by fully informed parties in a setting of zero transaction costs. Additionally, from a political perspective, it is highly desirable to create market game rules before engaging in the privatization of large enterprises. The process of writing the rules is likely to be less difficult prior to the growth of powerful private interests having highly specific ideas as to how the rules ought to be written. In addition, to the extent that the rules for the market are clear at the outset, one aspect of uncertainty (which creates its own transaction costs) is alleviated.

On the other hand, if a regime in which efficiency concerns are vindicated at the initial stage of distribution is preferred, then there are strong arguments for relying on auctions as a distributional mechanism. There are at least two principal arguments in favor of auctions.\(^3\) First, assuming an open bidding process with multiple, non-collusive bidders, auctions increase the possibility that bidders will reveal their true valuations, thereby enabling the auctioneer to allocate the asset to the bidder who values it the most. Second, the auction process creates powerful incentives for bidders to seek and obtain information about the assets up for sale and their possible uses in a future market economy. This information is extremely useful in a setting where the true value of the assets being auctioned is not even known to the state as auctioneer.\(^3\) The information thus generated is extremely useful in determining the value and prospects for future viability of the assets that are to be distributed.

Despite the fact that many of the privatization programs proposed for the NLCs are advocated based on their efficiency-promoting qualities, we are not at all confident that the auctions envisaged by the privatization programs will

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yield the expected benefits.\textsuperscript{32} To begin with, because of the undeveloped state of capital markets in the NLCs, a winning bid will, more often than not, be determined on the basis of the bidder's own \textit{ability} to pay rather than on the basis of \textit{willingness} to pay as efficiency requires. Without adequate sources of credit, high-valued but cash-strapped bidders will be precluded from participating in the auction process, leaving open the possibility that assets will wind up in the hands of wealthier but less efficient bidders. In an efficiently functioning market, of course, the capacity to pay will often depend significantly on previous success in entrepreneurship, and thus may have some value as a prediction of future entrepreneurial success. However, in the NLCs, many of those who have accumulated considerable wealth have done so as a consequence of special privileges of various sorts or by effectively playing by the rules of a non-market game.\textsuperscript{33} This discrimination in favor of financially solvent bidders heightens the importance of finding a way to open up the process to bidders with the highest willingness to pay. One solution would be to use the proceeds of an initial series of auctions as the seed capital for loans provided by private banks to talented but capital deficient entrepreneurs. Alternatively, the state itself could provide credit for the purchase of the enterprises.\textsuperscript{34}

Further compounding the difficulties of the auction re-

\textsuperscript{32} An alternative but far less desirable way of dealing with the prior endowments problem would be to eschew auctions altogether by having the state or a state-appointed agency invite individuals to apply for the property and then allow the agency to undertake an investigation aimed at determining who placed the greatest value on the property. However, even if it were possible to ascertain, through such a metaphysical search, the identity of that individual whose preference function placed the highest value on a given asset, its malleability would likely be corrupted by nepotism and graft. For these reasons, a superior alternative would be to involve international institutions such as the World Bank and the European Bank for Reconstruction and Development in both the funding and evaluation of competing bids for state assets.

\textsuperscript{33} Nevertheless, in order to translate these privileges into significant wealth accumulation, the individuals in question would find it necessary to also be successful to some degree in gray and black market activity. Notwithstanding the moral issues involved, one should not underestimate the extent to which experience with gray and black market activity builds genuine entrepreneurial skills.

\textsuperscript{34} See Lipton & Sachs, \textit{supra} note 29, at 21.
gime in existing privatization programs is the frequency with which governments have insisted upon and subsequently exercised a right of reserve. Presumably, the rationale for the reserve right is grounded in the concern that bidders will be able to purchase assets at prices below their intrinsic value. Nevertheless, given the gross uncertainties that plague the asset valuation process, it is not at all clear why the subjective valuation of a bureaucrat should be allowed to trump the collective judgment of the market, however primitive that judgment may be.

However, if there are grounds for believing that infirmities in the auction process have caused bidders to underprice assets, then the obvious solution is to provide direct remedies for these defects. For example, a bid that appears too low may implicate an inadequate dissemination to alternative potential bidders of information bearing on the availability and possible underlying value of the assets. Here the appropriate response would be to reform bidding procedures so as to encourage a wider range of bids, and to ensure that particular bidders do not have or appear to have an "inside edge," thereby discouraging alternative bidders. Governments must recognize that the quality and range of bids depends directly upon the incentive for potential bidders to invest the time and money necessary to locate the information required to establish an appropriate bidding price. The regular exercise by governments of their right to refuse the highest or sole bid by removing the assets from sale creates considerable uncertainty for potential bidders as to whether it is worthwhile to enter a bid at all.

Another way in which existing privatization programs deviate from idealized auction regimes is in the extensive reliance that some governmental privatization agencies have placed on pre-privatization analyses of industrial organization structure. Typically, these programs contain a heavy element of industrial planning that is reminiscent of the ex-


36. See Gabor, supra note 35, at 2; Goldstein, supra note 35, at 9; and
tensive role played by the state and various enterprise groups in predecessor regimes. These programs substantially delay the process of privatization. They also risk enshrining producer interests in the post-privatization regime or substituting public planning for private decision-making, which greatly increases the risk of sub-optimal resource use. While *ex ante* state planning is aimed at creating a sufficiently competitive products market in a given industry, a better way of achieving this goal would be to establish an antitrust regime applicable to privatized enterprises.37

In late 1991, the Hungarian government made a promising departure from the “industrial planning” approach to the privatization scheme.38 New legislation allows the method of privatization of a select group of about three hundred small- to medium-sized state enterprises to be determined by independent (mainly Western) management consultants.39 Managers of these enterprises may, on their own initiative, decide to proceed with privatization. In that situation, one of the authorized management consultants is responsible for deciding how the firm is to be privatized, choosing a buyer, and so forth, subject to a general requirement that there be open competition for ownership of the firm. The consultant’s compensation is five percent of the sale price, or ten percent in the case of a rapid sale.40 This incentive structure clearly veers toward a revenue-maximization approach to privatization. However, the higher commission in the case of a rapid sale provides a disincentive for a consultant to hold out for a long period of time in order to obtain the “best price,” thereby potentially undermining aggregate wealth-maximization goals. Unfortunately, these provisions apply to only fifteen percent of the firms that are


37. *See* Michael Trebilcock, *The Role of Competition Policy in Non-Market Economies in Transition: The Case of Hungary* (July 10, 1991) (unpublished manuscript, on file with the author). Trebilcock hopes that an advocate of this position would argue “strenuously, both publicly and privately, the virtues of policies relating to privatization, deregulation, foreign investment and trade policy liberalization.” *Id.* at 12.


39. *Id.*

40. *Id.*
to be privatized, which in turn represents only about five percent of the total assets that the Hungarian government intends to privatize.41

Another unfortunate feature of auction-based privatization schemes in the NLCs is the insistence that successful purchasers of auctioned property agree to comply with conditions relating to the maintenance of the existing enterprise structure which include prohibitions on the liquidation or transfer of assets and maintaining employment goals. These restrictions impede the desired reallocation of resources based on new information about the best uses for the resources under market conditions.42 Furthermore, buyers face increased risk because they will be required to make fixed commitments under conditions of profound uncertainty as to the revenues likely to be generated from the enterprises under market conditions.

This is not to suggest that privatization should take place without appropriate social security and other protections for workers. Rather, as will be argued below, such protections should be a separate but simultaneous track to the design of the privatization process, and should be achieved through taxes and transfers. Finally, limitations on the sale of state enterprises to foreign buyers are undesirable from a wealth maximization perspective (although they may possibly be defended under a national sovereignty perspective), since they reduce the range of bidders willing and able to generate information on the value of assets through the auctioning process. However, the political realities of Eastern and Central Europe—particularly the emergence of nationalist sentiments after fifty years of domination—have severely limited the political viability of direct asset sales to foreign investors.

B. Maximization of State Revenue

Another central goal of privatization is the maximization of governmental revenue from the sale of enterprises. By

41. Id.
42. HINDS, supra note 1, at 45, explains that factor mobility is crucial in establishing a market that reacts properly to market signals, and that if such mobility is to exist it is crucial that a substantial portion of state industries be rapidly privatized.
selling off state owned properties, governments are able to substitute a cash payment or a receivable of a fixed amount for an *in specie* asset of uncertain value. Assuming that auction markets are working effectively, the value of this fixed payment is equal to the net present value of future net cash flows. The proceeds from the sale of assets can be used by governments to increase the range and level of goods and services that they are expected to provide.

The need for governments to generate revenue has been a driving force for many privatization initiatives in Western and developing countries. Although originally embraced as a central component of privatization in the NLCs, government revenue creation is losing much of its lustre because of growing investor anxiety over the quality of the assets being distributed, the prospects of rehabilitation, and the socio-legal risks that affect the future value of these assets.\(^{43}\) Quite simply, in an environment characterized by capital scarcity, investors have been able to find more than enough high return, high risk investments without having to bear many of the additional risks inherent to investments in the NLCs.

Additionally, investors may prefer to establish new private firms or to export goods into the NLCs (effectively abandoning entry by way of the firm), rather than risk being burdened with the adjustment, environmental regulations, and other restrictions on existing state enterprises. Now that a relationship with an existing state enterprise is no longer a legal or practical requirement for conducting economic activity in the NLCs, it is not surprising that some of the interest in acquiring these assets has waned.

Nevertheless, governments in the NLCs continue to cling to the erroneous assumption that privatization can furnish valuable rents for the government, reluctantly acknowledging only that the timing for privatization may not be right.

Similar to a privatization scheme guided by global wealth maximization goals, privatization implemented to achieve government wealth creation requires interim government ownership coupled with extensive auctions. Such a

\(^{43}\) For a discussion of many of these issues, see *Business in Eastern Europe: Survey*, Economist, Sept. 21, 1991, at 14-18.
privatization scheme should also involve the establishment of clear and unequivocal property entitlements aimed at reducing the likelihood of title uncertainty that causes buyers to discount—by the probability that one’s ownership in property will be challenged and subsequently negated—the price paid for property. As before, the identity of the ultimate owners of the property is relatively unimportant.\textsuperscript{44} However, unlike the auction schemes motivated by global wealth maximization, privatization aimed at realizing government revenue objectives need not be as concerned with the limiting effect of prior endowments. After all, the object of the exercise is to maximize the amount of revenue received by the government, even if this precludes higher valued users from entering the auction by reason of wealth constraints. The innate indifference of government revenue driven privatization schemes to impecunious bidders is reinforced by the fact that rectification of these constraints is likely to require some on-budget expenditures that will reduce the net revenues to be expected from the sale of state assets.

This discussion evokes a more general point related to sequencing which is that the more clearly established the legal rules of market competition, the less uncertainty there will be among private buyers, and the more they will be prepared to pay for assets.\textsuperscript{45} Rules with respect to competition policy, taxation, corporate transformations, environmental protection, and occupational health and safety will have an enormous impact on the future value of the assets in question. Under conditions of fundamental uncertainty about the nature of these rules, it is not surprising that almost all investors (except possibly high-risk investors) would either make “low” bids or adopt a wait-and-see attitude. Of

\textsuperscript{44} However, if governments are concerned about improvements in their foreign capital accounts, there may be a premium on selling to foreign rather than domestic owners.

\textsuperscript{45} For a discussion about this tension, see J. French Hill, \textit{Rebirth of a Nation: The Difficulties in Eastern and Central Europe}, 24 \textsc{Vand. J. Transnat’l L.} 345, 347 (1991). “The new democrats pass private property statutes, declare and construct independent judiciaries, move to end central planning and price controls; but the old \textit{nomenklatura} ask, ‘who sells the property, decides the cases, plans the production, and sets the prices, if not a ministry?’” \textit{Id.}
course, in any market economy, private economic actors face the significant risk that future government action will affect the value of their investments.\(^\text{46}\) However, the uncertainties connected with a change in regime are of a different quantitative and qualitative order. Within that type of situation the basic rules of the marketplace, social deals or social contracts, and political coalitions are in a constant state of flux. In their discussion on the transition from authoritarian rule in Latin America and Southern Europe, O'Donnell and Schmitter noted that:

During these transitions and around many themes, it is impossible to specify ex ante which classes, sectors, institutions, and other groups will take what role, opt for which issues, or support what alternative. . . . Moreover, those actors are likely to undergo significant changes as they try to respond to the changing contexts presented to them by liberalization and democratization.\(^\text{47}\)

An alternative, of course, to postponing privatization until some of this uncertainty has passed is to provide firm-specific guarantees concerning future regulatory conduct. In market societies, it is quite frequent—where the future behavior of the seller can influence the value to the buyer of the asset sold—to make covenants that restrain the future conduct of the seller. A typical example of this are provisions that prevent the seller from competing with the buyer for a certain period of time. In the context of regime transition, guarantees that are firm-specific raise special concerns. Some provisions, such as those affecting the integrity of title, however, are quite benign, and are entirely consistent with privatization guided by wealth maximization.

On the other hand, as one moves along a continuum, it is clear that some of the guarantees that governments may offer to purchasers in order to increase the amount of proceeds generated by the sale of the asset may have quite a


destructive impact on wealth maximization objectives. For instance, assurances by the government that the purchaser will be insulated from the impact of anti-competition legislation or that the purchaser will receive preferential treatment from the government in procurement contracts will all work to increase the amount purchasers will be willing to pay for assets, but will also create a new set of special privileges that distort competition and hence undermine wealth maximization objectives.48

Thus, there appears to be a conflict between the wealth maximization and revenue maximization perspectives. One may well ask to what degree such guarantees are likely to genuinely increase the purchase price. Given the uncertainty about basic rules of the game, and the considerable instability in the political process, how will potential investors view the likelihood of such commitments being honored in the longer term? The guarantees in question may very well be repudiated or modified, especially if viewed by successor governments as unjustified special privileges or if considered illegitimate in the public eye. When one considers the high degree of political uncertainty at the present juncture, it is probable that such guarantees will be significantly discounted by bidders in auctions.

While it is clearly undesirable that states in the NLCs make assurances to prospective purchasers of enterprises that are aimed at thwarting normal competitive pressures, the case for making assurances that are aimed at relieving enterprises of their traditional welfare responsibilities to employees and communities is stronger. This case is not based on a belief that the costs of human misfortune arising, for instance, from unemployment or illness, should be left to lie where they fall. Rather, the argument is that the state should directly provide a basic social safety net, rather than imposing this requirement on enterprises.49 This is so for several reasons. First of all, the ability of an enterprise to meet its social obligations depends upon its solvency. The early

stages of a market economy in the NLCs are likely to be characterized by a large number of enterprise failures and the establishment of many new businesses that will, at the outset, lack financial stability. This will, in turn, render an employer-based safety net highly tenuous for many workers. It will also increase pressure on the state to impede the market by not letting firms fail in order to protect the social entitlements of workers. Of course, one possible solution would be for the state to back or guarantee the social obligations of firms against the risk of insolvency. However, in this circumstance, unless the state was prepared to accept the full moral hazard of such an insurance policy, it would want to control the riskiness of firm conduct. This would then set the stage for a new kind of interference in micro-economic behavior. Secondly, under an employment-linked system of social protection, certain classes of particularly disadvantaged persons are likely to “fall between the cracks”—unemployed youth, the chronically ill, and the disabled: indeed anyone without an entrenched position in an established enterprise. Ironically, some of the most disadvantaged groups end up being the least protected.50 Thirdly, employment-based social welfare entitlements also raise problems for efficiency values. With receipt of social welfare entitlements tethered to employment, labor mobility, an essential feature of a free market economy, will be undermined. Already, there is ample evidence in the NLCs of a “lock-in” effect, whereby employees are reluctant to leave their existing jobs for better jobs elsewhere in the country because of the fear of foregone welfare and pension benefits.51 By shifting the provision of benefits from the enterprise to the state, the employment deci-

50. Indeed, this is an increasingly recognized problem with some West European versions of the social welfare state that depend to a great extent on the imposition of social obligations on enterprises. A growing underclass without long-term unionized employment in large firms or in government finds itself largely unprotected by the social welfare state.

51. For a discussion of the myriad obligations of state aimed enterprise to the community, see Peter Cook, *Wanted: People to Take Responsibility*, *Globe & Mail*, Oct. 26, 1991, at B18 (citing the case of Huta Warzawa, a Polish steel maker, which is required to fund the activities of a local hospital, housing estates, state farms, schools, and sport teams, as well as its workers’ free lunches and holidays).
sion is isolated from the benefits decision, thereby commensurately enhancing labor mobility.

Given that assurances made during a period of regime change carry a considerable risk of non-fulfillment, whatever assurances are offered concerning the future rights and obligations of the enterprise, it is likely that significant discounting for uncertainty will nevertheless occur. From a revenue maximization perspective, it might seem at first glance desirable for the government to refuse bids it perceives as too low, in the hope that a higher bid will come along at a later time. As noted above, however, the effect may be to put a damper on bids, thereby decreasing the likelihood of sale altogether. Considerable delay has already occurred in the privatization process out of fear that governments will somehow be cheated of revenue by buyers whose assets under market conditions turn out to be far more valuable than predicted. A related fear is that some buyers may simply turn around and liquidate the assets, thereby realizing revenues greater than the sale price and at the same time imposing considerable social costs on the state from worker dislocation. If the government wishes to create a disincentive to short-term liquidation of assets by new owners and instead encourage long-term restructuring, it can do so by imposing a form of speculation or turnover tax. However, from a wealth maximization perspective, it may be undesirable to discourage such activity, which does have the potential to rapidly reallocate assets to higher valued uses.

52. If the government wishes to create a disincentive to short-term liquidation of assets by new owners and instead encourage long-term restructuring, it can do so by imposing a form of speculation or turnover tax. However, from a wealth maximization perspective, it may be undesirable to discourage such activity, which does have the potential to rapidly reallocate assets to higher valued uses.

53. See, e.g., Lipton & Sachs, supra note 29.
mistakes in the auction process. Once the possibilities for at least partial governmental recovery of profits “lost” through fire sale prices are acknowledged, the reasonableness of forestalling privatization to protect government fiscal objectives becomes deeply suspect. This is especially so when one considers both the efficiency losses that are experienced when valuable resources are left to languish in the hands of government and the external costs to the whole transformation enterprise by slowing the transfer of power. At the same time, it should be understood that purchasers of state assets are taking high risks, and it is legitimate that these risks be accompanied by the possibility of realizing profits where an enterprise turns out to be highly valuable. Punitive taxation of the gains from resale of state enterprises, or more generally, of capital gains, will only serve to reinforce the prejudice ingrained under socialism that arbitrage profits constitute illegitimate “speculation.” In fact, such profits provide crucial incentives to reallocating resources to higher valued uses as well as stimulating investment in information that allows more accurate evaluation of assets. In this connection, it is important to institute effective measures for tax compliance as well as to define and identify fraudulent trade practices and to allay suspicions that high profits are necessarily the product of fraudulent or other inappropriate practices (e.g., abuse of insider information or corruption of government officials).

C. Decentralization and Fragmentation of Political Power

A third role for privatization focuses on the political part of the reform agenda for Central and Eastern Europe, and envisages privatization as a vehicle for the decentralization and fragmentation of political power. Specifically, by transferring property previously held under state stewardship to domestic citizens, the power of citizens to check the concen-

56. In Poland, the failure of individuals and companies to pay their taxes has been particularly acute. See Poland Loses Heart, ECONOMIST, Feb. 22, 1992, at 41.
trated exercise of political authority is correspondingly enhanced.\textsuperscript{57} Demonopolization of former governmental assets promotes this objective by providing private citizens with independent sources of productive resources, which in turn helps reduce the leverage available to governments or their delegates through the control of productive resources within the state. Once an individual knows that her assets are protected from unilateral and capricious control by governments, she will more confidently challenge governmental authority. These challenges may be expressed in as simple a way as by providing financial contributions to opposition political parties.

Aside from fragmenting concentrated political power by empowering citizens, privatization will also remove the state's power to reward and penalize citizens for loyalty or disloyalty to an individual or idea. The legacy of communism in Central and Eastern Europe provides a poignant example of the various ways in which carrots and sticks, including educational opportunities, jobs, and preferential access to scarce goods, were meted out in order to coerce commitments to ruling elites. The transfer of assets to the private sector, especially when accompanied by the rise of private markets, will make some of these perquisites (e.g., preferential access to scarce goods) valueless. While some types of rewards (e.g., a lucrative job) will still be valuable in a privatized economy, a private sector dedicated to profit maximization will be disinclined to award these perquisites on political grounds, as doing so will likely inflict unnecessary costs on owners of the assets.

A privatization program oriented toward the implementation of political fragmentation goals requires considerable sensitivity on the part of the state to the identity of the ultimate owners of distributed property. Instead of allocating property to those individuals having either the greatest willingness (pursuant to wealth maximization) or ability (pursu-

\textsuperscript{57} See, e.g., Milton Friedman, Capitalism and Freedom 9 (1982). "Viewed as a means to the end of political freedom, economic arrangements are important because of their effect on the concentration or dispersion of power." \textit{Id.} See also Walter Lippmann, The Method of Freedom 100-02, 110-14 (1954); and Charles A. Reich, The New Property, 73 Yale L.J. 733 (1964).
ant to government revenue maximization) to pay, this objective requires property to be distributed on criteria, such as the Rawlsian difference principle, that are sensitive to disparities in the existing distribution of wealth. Such a program would appear to provide a basic level of economic security for all citizens. It will also vindicate autonomy concerns by ensuring that all citizens enjoy the material wealth necessary to support the basic conditions for individual action. It is possible that under such a scheme certain political minority groups that hitherto have been systematically excluded from economic benefits will gain a disproportionate share of distributed resources. A possible further refinement of a scheme motivated by political fragmentation goals would be the imposition of restrictions on alienability of assets to ensure that the wealth represented by *in species* property entitlements remains with the original recipients of the property.

While privatization schemes motivated by government revenue maximization goals are not inherently inimical to global wealth maximization goals, the same cannot be said of privatization schemes designed to vindicate political fragmentation objectives. This is because widespread economic empowerment of citizens through privatization causes *de facto* severance of ownership and control of assets, resulting in the loss of economic wealth. This in turn enhances the prospect of very severe agency problems. Such programs of "peoples' capitalism" may also do little to distribute political and economic power. They merely shift power from one set of elites (politicians) to another (unaccountable managers). While one widely touted solution to the agency problems between managers and investors involves the introduction of institutional intermediaries, the effect of this modification will be to shift the agency problems back a level to intermediaries and investors, while simultaneously creating new and powerful foci of economic power in the institutional intermediaries.58

Some of the difficulties in such privatization schemes can be seen by a preliminary examination of recent Czechoslovak legislation that has implemented privatization

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through the sale of vouchers to the general public.\(^59\) The legislation envisages that each citizen would have a right to purchase a given quantity of vouchers for a set sum of one thousand Crowns.\(^60\) During each "round" of privatization, shares of certain state enterprises would be offered for sale in exchange for these vouchers. The rate of exchange between shares and vouchers for each enterprise would be determined by the government.\(^61\) As an alternative to exchanging vouchers for shares in particular firms, vouchers may be exchanged for shares in "investment funds" that would in turn acquire a portfolio of shares of various privatized companies.\(^62\) Where demand for shares of a particular company, during a round, exceeded the supply, no shares of that company would be sold.\(^63\) Instead, the sale would be postponed to the next round; however, the price of the shares would be increased.\(^64\) Where supply equalled or exceeded demand, all orders would be filled. The likely result of this system is that in the initial round of privatization, the investment funds would end up with large quantities of relatively unpopular shares (those for which all orders could be filled), while the sale of companies that attracted strong investor interest would be postponed to later rounds. In effect, the investment funds would be starting off with portfolios consisting primarily of shares in the less saleable enterprises—a result hardly likely to inspire longer-term public confidence in these funds.

While the participation of Czechoslovak citizens in the sale and registration of the voucher books has been widespread (by the February 29, 1992 deadline for the sale of voucher books, over 8.6 million had been issued),\(^65\) the actual process has been fraught with many shortcomings. A serious concern is the system's lack of regulatory or remedial

\(^60\) Id.
\(^61\) Id.
\(^62\) Id.
\(^63\) Id.
\(^64\) Id.
\(^65\) Peter Passell, A Capitalist Free-for-All in Czechoslovakia, N.Y. Times, Apr. 12, 1992, § 3, at 10.
structures, thereby creating the potential for serious abuses both now and in the future.\(^66\) Since the introduction of the voucher privatization program, the failure of the Czechoslovak government to implement either a more functional disclosure system or a more stringent framework for investor protection has been highlighted by the occurrence of a number of incidents.

The lack of a comprehensive, functioning system of financial disclosure has hampered the voucher system from the very beginning. Originally to be implemented on January 1, 1992, the voucher plan was delayed in November 1991 because there was no way for the government to accurately assess the value of the assets it planned to sell at auction.\(^67\) Although shares in these auctioned companies are being virtually "given away," it is imperative that the government have a good indication of the share value if it is to accurately establish their worth in terms of vouchers for the initial stock offering. Likewise, the lack of an adequate method of disclosure makes purchasing shares a largely hit or miss proposition, thereby severely undermining novice investor confidence in the share ownership system.\(^68\)

In addition to these concerns, there is the risk that insider trading will proliferate due to the lack of an adequate disclosure system. Without any sort of regulatory framework to guide investors' actions, insider trading could prove to be a very real problem for the fledgling markets of Czechoslovakia.\(^69\) Lack of a regulatory system to govern movement of shares created problems in Czechoslovakia even before the voucher system became fully operational. The most significant problem to date has been caused by independently formed investment companies buying up a large percentage of the available voucher books; if a citizen wants to register a

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\(^68\) In Poland, this problem has been addressed by making citizens only indirect shareholders—by way of holding companies—in the privatized enterprises.

\(^69\) Passell, *supra* note 65.
voucher book, she must often turn to one of these funds.\footnote{Czechs by Millions Invest \$35 in Big State Sale, N.Y. Times, Jan. 21, 1992, at A7.} One enterprising fund manager, by promising investors a ten-fold return on their money within one year, has managed to capture nearly twenty percent of all the voucher coupons sold to date.\footnote{John Tagliabue, \textit{Hot to Invest? Trust a Man with a Harvard Past?}, N.Y. Times, Mar. 6, 1991, at A4. As of May 19, 1992, over four hundred mutual funds had been set up in Czechoslovakia. These funds had acquired approximately 55% of the voucher points issued prior to the initial sale of state owned enterprises. Roger Cohen, \textit{Czechoslovakia a Bull Market as State Grip Yields to Stock}, N.Y. Times, May 19, 1992, at A1.}

These kinds of actions present two problems to privatizing governments. First of all, there is the concern that ownership of industry will remain extremely concentrated since it will simply pass from state ownership to a few vast monopolistic, and vertically integrated ownership structures, with one form of economic domination being replaced by another. The second, and perhaps more tangible, fear is that these investment funds do not have sufficient capital to even remotely cover the guarantees that they are making to their investors. Any kind of run on these funds would leave fund managers struggling to raise capital to meet investor demands.\footnote{Passell, \textit{supra} note 65.} The only way to meet such demands would be for the funds to quickly strip the companies they control of their assets. While this would, in a sense, constitute the functioning of market forces, a purpose of the privatization program is to place companies in the hands of investors who will make them functional and not merely break them up and sell the pieces.

The efficiency losses from a privatization program inspired by political fragmentation may be especially great if coupled with other features designed to reinforce the wealth-creating effects of the initial transfer of property. If, as expected, the \textit{ex post} value of entitlements received by different individuals differs (a probable outcome given heterogenous bundles of initial entitlements), the state may be predisposed to periodically readjust entitlements, thereby ensuring formal equality. Predictably, such interventions and their accompanying uncertainty do considerable violence to the in-
tegrity of property entitlements required for private economic planning, and further threaten to reintroduce the specter of unwarranted state intervention in citizens' lives. These interventions thus effectively impair both wealth maximization and political fragmentation objectives. Similarly, if the government decides to introduce restrictions on share alienability so as to maintain widely dispersed share ownership, the emergence of active capital markets will be thwarted. Even more seriously, higher valued users of property will be precluded from gaining control of the assets through subsequent disposition.

Privatization programs aimed at power decentralization will also collide with privatization programs designed to generate government revenue. Whereas the former may require the giving away of assets directly to the least advantaged without any requisite payment, the latter are premised on the assumption that assets should be sold to the most affluent citizens who have the greatest ability to pay. These latter programs would thus systematically exclude the least materially advantaged from property ownership.

It may be quite dangerous to view dispersal of state industrial assets among the population at large (through vouchers or any other system) as an appropriate means of citizen empowerment. First of all, such entitlements are highly unlikely to lead to economic security, at least in the short run. Even if citizens are given shares or vouchers to trade for shares in a mutual fund containing a fairly wide selection of companies, as some of the more sophisticated proposals advocate, the security of the entitlement will depend upon the quality of fund management. Inadequate information regarding the value of assets under market conditions, at least in the near future, will likely lead to trading decisions based primarily on speculation and rumor. Some proposals, however, envisage that the funds would not engage in active trading in the short term, i.e., they would hold shares of a fixed group of companies, and have some role in supervising those companies' management. 73 From a wealth maximiza-

73. Blanchard et al., supra note 25, at 31-42; Roman Frydman & Andrzej Rapaczynski, Markets & Institutions in Large Scale Privatizations (Working Paper no. 49, in the Center for Law and Economic Studies, Columbia University School of Law at 7, 25-37); Andrzej Rapaczynski & Ro...
tion perspective, this stability would be bought at the price of severe restrictions on the market’s ability to reallocate capital.

In order for equity holdings to constitute the economic security of the ordinary citizen—although such holdings do not generally constitute the ordinary person’s main form of economic security, except perhaps in the United States—extraordinary protections are required against abuse, corruption, and instability. To adequately protect the interests of small investors who have little independent capacity to monitor the market or the activities of management, while at the same time allowing the market sufficient freedom to do its work, requires a very carefully crafted regime of securities and corporate law regulation. Striking this balance at the initiation of market activity, in an environment of fundamental uncertainty about values and in the absence of sophisticated professional analysis, is likely to be impossible. There exists a very real risk that early instances of abuse or even high volatility that negatively affect the economic security of ordinary people will lead to irresistible demands for a clampdown on market activity that may perhaps extend well beyond capital markets.

In addition to the rationale for a move toward decentralization, distribution of shares to the population at large has been advocated based on the premise that it is the people at large who now actually “own” the assets, and who should benefit from the assets in the future. This argument seems to have been derived from the nature of equity ownership—such ownership is not really ownership in a fixed stock of

[74] In many cases, workers wonder what the fuss is about, because of course they own the firms. And communist managers in many firms have simply assumed the right to trade, lease, merge, or even sell the enterprise assets, often for their own enrichment and to the fury of the public.

Lipton & Sachs, supra note 29, at 128. See also Hober, supra note 73, at 2, 10 (discussing the conceptual problem of determining who owns the state enterprises).
wealth, but rather an entitlement to a portion of a future earnings stream. In selling enterprises, the state need not be viewed as having abandoned its claim on their future earnings stream, but rather the claim now involves the taxation of profits. As such, the state is rendered a contingent claimant of sorts on the firm's income stream, sharing in both the profits and losses of a given enterprise. Under these terms, once a comprehensive and effective tax system is put into place, governments will be able to raise capital for a variety of social programs, enabling them to more accurately target a given set of recipients so as to vindicate substantive rather than merely formal notions of equality. Of course, given the anti-statist thrust of decentralization arguments for privatization, this course would be undesirable since the state is the necessary intermediary in the redistribution of wealth from private economic activity.

In this context, it would be very naive to regard equity holdings as a kind of absolute property entitlement that the state cannot affect so long as it respects the rule of law. It is well known to those familiar with advanced capitalism that the state plays a vital role in making and enforcing the rules for markets in equity, thereby ensuring fairness and stability. In the absence of competent, impartial, and non-corrupt regulators, having the power to enforce good legislation, abuses of private power are as likely to jeopardize the economic security of citizens as abuses of public power did in the past. Faith in the market is not a substitute for, but rather depends upon, faith in the state. The reform process as it now stands requires a greater focus on reforming public administration by training regulatory officials and implementing measures designed to create credible and competent public institutions. In focusing on the purported advantages of privatization as a means of ending state involvement in economic life, many commentators unfortunately have diverted atten-

75. Of course, there is a sense in which equity ownership is a claim on fixed wealth. Typically, shareholders have a residual claim on assets at liquidation or break-up; however, this claim is subordinate to the claims of the firm's employees and other creditors.

76. Eberstadt suggests that the rectification of institutional maladjustments—to protect individual rights and enforce private contracts—is one of the largest obstacles to privatization. Nicholas N. Eberstadt, How Not to Aid Eastern Europe, COMMENTARY 92(5) (November 1991).
tion from the need to build strong states in the NLCs, and have simply focused on one narrow version of liberalism: the idea that freedom is dependent upon less government. These commentators have ignored the philosophy underlying the success of contemporary liberal and social democracies, namely, that freedom requires a strong but limited government.

D. Compensatory Justice

In this section, we consider issues of compensatory justice in the privatization settings of reprivatization and market transitions.

1. Reprivatization

One of the rationales for privatization in Central and Eastern European states is the need to rehabilitate the legitimacy of the state by compensating citizens for wrongs suffered under their predecessor communist regimes. Usually, this compensation has taken the form of restoration of wrongfully seized property, but sometimes a monetary equivalent is offered instead. Broadly stated, the purpose of reprivatization is to rehabilitate respect for the state and the rule of law by celebrating the cherished values of personhood and peoplehood that lie at the core of civilized society. It is thus ironic that an enterprise so filled with noble aspirations has become the achilles heel of privatization in the NLCs. The difficulties with reprivatization can be found at several different levels, ranging from a core conceptual disagreement about the content of compensatory justice to problems of determining eligibility for compensation, and the compatibility of compensatory justice with other privatization goals.

In contrast to the relatively clear set of principles that supports privatization's other objectives, compensatory justice is much more difficult to define as a determinate goal. In large part, this reflects the complex relationship between the principles of corrective and distributive justice that are inherent in any compensatory justice scheme. The principle of corrective justice can be traced to Aristotle, and is invoked to redress harms inflicted on the innocent. Corrective justice requires that the value of ill-gotten gains be transferred from the wrongdoer to the victim. In determining the magnitude of redress, corrective justice looks only to the gains which were wrongfully appropriated from the victim, and is blind to the relative merits, wealth, or virtue of either the wrongdoer or the victim.

In the context of privatization in the NLCs, the tension between corrective and distributive justice is evidenced by the competing claims of those individuals whose injury does and those whose injury does not reflect some tangible act or decision undertaken by a predecessor communist regime. An example of the former would be the harm suffered by an individual citizen as a result of the nationalization of her house and shop. This injury would substantiate a claim for corrective justice. On the other hand, those citizens who were not property owners prior to communist revolutions may still have a claim to compensation that sounds in distributive justice. This claim may be based on some systematic discrimination or exclusion that pre-dates the change in government. The fact that some intervening event (e.g., a communist revolution) has occurred, which has deprived other wealthier citizens of their property, may not be sufficient to extinguish the original claim.

Assuming that the tension between distributive and corrective justice can be resolved, perhaps by vindicating only corrective justice objectives through a reprivatization scheme, the question then becomes one of eligibility. That is, who will be entitled to benefit from corrective justice?

For which acts? Who will supply the benefits? And to what extent? These questions pose difficult, almost intractable challenges to privatization architects. In contrast with the relatively straightforward case where one individual harms another, compensatory justice implemented on a national scale requires collectivization of both responsibility for harm and entitlement to redress. The move from individual to collective responsibility is, however, extremely controversial. 82 To a large extent, opposition to collectivization reflects the difficulty in identifying discrete groups of perpetrators and victims. However, where a political majority perpetrates injustice against a discrete minority (the case of interned Japanese-Canadians and Americans, or Jewish victims of Nazi Germany), it is possible to identify the specific groups of perpetrators and victims, and thereby assign collective responsibility. As a result, determinations as to compensation are simplified.

In the case of reprivatization proposals in Central and Eastern Europe, however, even progressing this far is a virtually impossible task. Vaclav Havel, in one of the most persuasive and sophisticated analyses of the nature of totalitarianism in Central and Eastern Europe, has presented a picture of a system in which nearly every citizen in some significant sense was both a victim and a perpetrator of the injustices of totalitarianism. 83 At the extreme, many dissidents were also police informers, and many of those who lived by totalitarian terror died by it as well. In these circumstances, singling out those who have suffered confiscation of property as the relevant set of victims becomes highly problematic. Compensating these individuals with public revenues that are needed for society at large seems morally problematic, especially in the absence of a legally coherent program designed to reclaim the wealth accumulated by certain individuals under the old system. This problem is further complicated where the state lacks a comparable system for

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82. For some of the difficulties of collectivizing corrective justice, see James S. Fishkin, Justice Between Generations: Compensation, Identity, and Group Membership, in COMPENSATORY JUSTICE, supra note 80, at 85.

compensating the victims of other forms of injustice such as torture, imprisonment, and suppression of free speech.

Further compounding these difficulties is the perplexing question of what date to set as the cut-off for compensation claims. By restoring property to previous owners, reprivatization implicitly endorses the distribution that existed as of the cut-off date. However, given the history of the Eastern and Central European region in the twentieth century, the selection of any such date would cause problems. Thus, determining a generally acceptable cut-off date becomes an impossible task, because in the absence of a coherent justification for the initial acquisition of property, virtually any distribution of property may be questioned.84

The difficulties inherent in the identification of a cut-off date are sharply illustrated in the Czechoslovak reprivatization scheme. In determining the potential beneficiaries of compensation, the state debated several different cut-off dates—the further back in time the state went, the broader the class of persons to whom the state was providing redress. By selecting 1946 as a floor for recovery, the state implicitly denied rights of recovery of property to Czechoslovakian Jews whose property was taken by the Nazis in 1939 and to other citizens whose property was “invited” to be donated to the state during the short lived coalition government that existed between 1945 and 1946. By compensating or returning property to individuals who themselves may have acquired it against a background of illegitimacy or injustice, the state violates its own principle concerning the purification of title.

These concerns are far from hypothetical. In a recent ruling, the Hungarian Constitutional Court struck down a reprivatization law on the grounds, inter alia, that it did not state a rational basis consistent with the Constitution for compensating only those whose property had been taken after 1949 (the Communist revolution), while leaving confiscations from the Jewish minority in 1939 and the German minority in 1944 uncompensated.85 Following this ruling the government submitted a proposal for the enactment of a compensation law encompassing the period from May 1,

85. Klingsberg, supra note 78, at 1-2 (describing The Compensation Case III (Decision 28/1991 (VI.3) AB)).
1939 to June 8, 1949, and establishing a maximum compensation level for this period of US$64,000.86

Eligibility problems are but one example of the very serious dangers lurking within any reprivatization scheme. Although the policy is designed to restore respect for the rule of law, the very contentious line-drawing exercises, which are often motivated more by pragmatism than principle, are sure to subvert that enterprise. Rather than remaining an exercise based on objective, dispassionate principles, reprivatization has become a policy rooted firmly in caprice and wedded intimately to narrow interest group politics.

Perhaps the most discouraging part of reprivatization is the considerable cost imposed on the other vaunted goals of privatization. At the most basic level, reprivatization requires a fairly elaborate administrative structure in order to deal with the myriad claims for return of previously owned property. Against established criteria, every claim for return of property will have to be processed and assessed by a central agency. Where there is more than one claim to a single property, the agency will have to determine whose claim is valid. In the event that there are multiple, equally valid claims to the property in question, the agency will have to determine how the claims can be reconciled with one another. Of course, in order to bolster the legitimacy of the process, it will be necessary to include some right of review, either to an independent agency or the judiciary.87

Strictly in terms of the funds necessary to establish and operate an apparatus along the lines contemplated above, reprivatization is likely to be an extremely costly enterprise. However, confining one’s attention to budgeted expenditures grossly understates the real costs of reprivatization. Additional societal costs will be generated by the plethora of private actors whose energies will be consumed by the process. Already there is strong evidence that many of the best educated and most sophisticated professionals (e.g., lawyers


87. The more onerous the requirements of procedural fairness attached to these determinations the greater the danger of a dispute if the property is returned quickly to someone in the private sector, thereby deterring long-term investments in property rehabilitation.
and accountants) are focusing their energies on reprivatization. It is very striking, in view of the many perplexing and difficult transition issues confronting the NLCs and their overwhelming scarcity of human capital, that the very best people in the NLCs find themselves mired in the essentially backward-looking enterprise of reprivatization. Rather than entangling themselves in the task of sorting through the rubble of conflicting claims to property, it would make far more sense for these individuals to direct their skills and expertise toward other public services. Their talents can be used to counteract the drag placed on the reform process by the remaining old guard bureaucrats.

Apart from the out-of-pocket costs, the most serious costs of reprivatization are caused by the delays and uncertainty created by the administrative review of competing title claims. For example, in the case of lands expropriated by the former East German government, it is estimated that it will take more than forty years to settle all of the filed claims.88 Indeed, in what was formerly East Germany, more than one third of the total land mass will be affected by reprivatization.89 In Potsdam alone, more than six thousand claims for property have been filed, representing more than 85% of the property in the downtown core.90 Clearly, with title to property subject to so much uncertainty, the efficiency goal achieved by moving properties quickly to their highest valued uses will be seriously undermined. Moreover, even after this property is transferred, it is unlikely that the beneficiary will be the highest valued present day user of the property, thereby necessitating a further transfer.

Unfortunately, despite these complications, it seems inevitable that restoration or compensation for confiscated property will proceed in some form.91 If that is the outcome,

89. Id.
90. Id.
91. In this vein, KORNAI, supra note 23, at 46, has argued that the restoration of property should not be a “number one priority” of the reform enterprise. For Kornai, the most important thing is “to declare in a trustworthy manner that there will never again be another confiscation.” Id. However, Kornai would allow return of lands to the peasantry, although he does not explain why he would carve out this exception. Id.
the programs devised should be responsive to certain concerns. First, in order to ensure that these programs support rather than detract from the rule of law, they should be sensitive to the wide range of harms suffered by citizens in the NLCs. Elevating the unjustified takings of property to a position of singular importance makes a mockery of the law and is bound to bring the entire process into disrepute. Breaches by the NLCs of their obligations under such international treaties and covenants as the Universal Declaration of Human Rights\textsuperscript{92} may serve as the basis for supporting such compensation. Second, while recognizing that infinite retrospective rectification of previous unjust acquisitions of property should be avoided, it seems sensible that the cut-off date for claims be pushed back to include unjustified takings of property during the inter-war years.\textsuperscript{93} The rationale for selecting this time period is based on the fact that many of the NLCs first emerged as modern states during this period. Thus, there is some continuity between the past and the present political units.\textsuperscript{94} Third, one way to lessen the deleterious impact of a reprivatization program is to sever the connection between the recognition of past wrongs and the actual restoration of \textit{in species} property. This severance could be achieved by adopting a program similar to the reparations schemes used to compensate Jewish victims of Nazi Germany, and Japanese internees in the United States and Canada. Such a program would ensure that compensation objectives are not detrimental to wealth maximization goals.

2. \textit{Compensation for Entitlements Disrupted by the Transition to a Market Economy}

The mirror image of the reprivatization issue is the issue


\textsuperscript{93} The proposed Hungarian Compensation Law for the period of May 1, 1939 to June 8, 1949 is limited to those losses falling within Hungarian territory as defined by its post-World War II borders. See Karoly Okolicsanyi, \textit{Hungarian Compensation Law Proposal Covering the 1939-1949 Period}, PARKER SCH. SURV. E. EUR. L., March 1992, at 5.

\textsuperscript{94} Successor liability in international law is discussed by Taracouzio in terms of the degree to which fundamental revolutionary changes in the political organization of a state mitigate against the enforcement of certain, pre-existing obligations. TIMOTHY A. TARACOUZIO, \textit{The Soviet Union and International Law} 235-90 (1935).
of compensation for disruption of entitlements such as employment, security, and housing that were established under the previous regime. One approach to this issue would be to consider these entitlements as no longer enforceable since they were the product of a previous unjust order. There is also a line of argument that one often hears in Western neo-conservative circles, namely that now that people in Central and Eastern Europe have chosen capitalism they must be prepared to suffer the pain of market dislocations.\(^95\)

Both these perspectives are largely erroneous. With respect to the first approach, it derives from the context in which the social deals or contracts were originally made. These contracts, however, already reflect somewhat of a transitional order, particularly in the case of Hungary and Poland. After the Czechoslovak revolution of 1968, a conscious decision was made in both Hungary and Poland to base their citizens' obligations to the state less upon the ideological "truth" of communism, and more upon the state's capacity to offer stable employment, social benefits (albeit not of very high quality), and increased prosperity.\(^96\) Citizens traded political and economic freedom for a modicum of security and comfort. Minimal demands were placed on workers, and in return they accepted minimal compensation.\(^97\) Long before the revolutions of 1990, the legitimacy of the state in Hungary, Poland, and even Czechoslovakia depended upon their abilities to keep their end of this bargain rather than upon Stalinist terror or ideological fanaticism. Many people joined in the 1989-90 revolution because they saw that sacrificing freedom for comfort was an inequitable bargain. Others did so because the state had increasingly become incapable of keeping its part of the bargain, or because they saw in the example of modern social welfare states a model that did not seem to require those trade-offs.

In the privatization process, proposals that give workers and managers a portion of shares in newly privatized enterprises for free or at a reduced cost imply a right to be compensated for disruption of previous claims or entitlements.

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96. *See* Havel, *supra* note 83; *see also* Batt, *supra* note 20.
97. *See* Havel, *supra* note 83; *see also* Batt, *supra* note 20.
with respect to the enterprise. However, the current "compensation," which may amount to little more than a worthless share of a worthless company, may be a poor substitute for the previous social contract that offered employment security through the enterprise. One saving grace is that the value of the enterprise will be directly related to its performance under market conditions rather than to the performance of the workers and managers according to some other form of measurement.

Alternatively, allowing workers’ councils or managers to block or delay privatization of particular enterprises is undesirable from both wealth maximization and corrective justice perspectives. According to the former standpoint, the delay in reallocating resources on a market basis would be very costly, and there is the prospect that workers and managers would use their blocking power to secure from the employer various guarantees, such as employment security and wage levels, thereby making future reallocation of productive resources much more difficult. 98 From a corrective justice perspective, the right to block allows workers and managers to hold out for whatever compensation they deem sufficient. However, a corrective justice perspective based upon legitimate expectations would suggest that compensation be based on normative criteria related to the nature of the expectation interests held by specific claimants to the entitlements in question.

More concretely, the disruption of entitlements under the old order has different implications for different classes of workers. Middle-aged or older workers with few transferable skills who have personal attachments to particular communities will clearly suffer considerable losses from the disruption of entitlements. Moreover, they will likely have limited opportunity to reap many of the benefits of a transition to markets. Younger workers and managers, meanwhile, will bear short-term or medium-term losses and risks as a consequence of the disruption of entitlements. However, that disruption will itself be intimately linked to the release of a wide range of new opportunities. This insight has, we believe, very important consequences for sequencing. Demands for compensation due to the disruption of old entitlements will

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98. Lipton & Sachs, supra note 22, at 298-99.
be of far greater moral and political salience at early stages in the transition process when new opportunities that arise from transition are scarcer and more uncertain. Large-scale privatization, involving a massive disruption of former entitlements, is likely to raise fewer obstructive corrective justice issues once a much larger and clearer range of new opportunities is available to workers who are encumbered by the disruption. This is not simply a political insight but is quite consistent with the corrective justice theory's rejection of unjust enrichment. Once it is understood that the disruption of entitlements through privatization is not a discrete state act within stable rules of the game, but rather is part of an alteration of the rules that opens up opportunities as well as creates costs for all those affected, the principle of unjust enrichment will kick in to insure that compensation is net of any new benefits or opportunities provided by the transition.

As long as costs are real and immediate, and benefits are largely hypothetical and prospective, the compensation problem may well prove intractable. However, the picture is in many respects far from bleak. Liberalization of private economic activity has itself resulted in a burst of new opportunities, reflected in the burgeoning of small businesses, especially in the service industries, in a number of Central and East European countries. A graduated privatization program that balances worker dislocation with the emergence of new opportunities, and which involves extensive job search and retraining services may, from this perspective, prove to be a more workable solution.99 Moreover, it is likely that workers and managers will attempt to hold on to old entitlements to a much greater extent in the presence of considerable uncertainty about the content of the new social contract. Some commentators see the privatization process as privatizing the question of the new social contract, which will emerge out of market relations. This is fundamentally wrong. The way in which workers view the attractiveness of market relations will depend, to a significant extent, upon various factors, such as the broad guarantees against high unemployment that are implicit in the overall government policy, and the type and extent of wage protections. In other words, the issue of the attractiveness of market relations de-

99. See Blanchard et al., supra note 25, at 90.
depends on whether a Keynesian or some other kind of social deal exists between capital markets, labor, and the state. Privatization is thus not a substitute for the state having to face the broad social and economic claims of workers. On the contrary, until those claims are fixed in a new social contract, there will be very powerful incentives for many groups to hold on to some commitments from the old contract. This is why proposals aimed at very rapid privatization are generally inoperable. Since it is difficult to craft a proposal acceptable to those with strong interests to protect, the rapid approach is less likely to inspire confidence in the transition to a market economy than undertaking a gradualist approach that marches in step with other reforms that clarify the rights and obligations of labor, capital, and the state under market conditions.

III. CONCLUSION

As the twentieth century draws to a close, the liberalization of Central and Eastern European societies is an immense and complex challenge that confronts the world community. A core component in the revitalization of the NLCs is the creation of social contracts that fundamentally realign the relationship between those who govern and those who are governed. Such understandings are crucial in order to effectuate a workable privatization policy.

In considering the content of these contracts, Western analysts should recognize the powerful appeal that the social welfare state has in these settings. History has revealed that these arrangements are remarkable for their power to offer citizens hitherto unimagined levels of prosperity and freedom within the embrace of a compassionate state. Nevertheless, given the considerable economic surplus necessary to fund the ambitious redistributive goals of the social welfare state, the daunting challenge for the West is to determine whether and how NLCs will be able to create such a state despite their current lack of, or limited access to, economic resources. An unacceptable solution will be to delay construction of a social welfare state until such time that it can be funded by the citizenry. Given the high level of destabilization that has arisen, and will continue to arise during the transition from communist to liberal market based
societies, delay will ultimately lead to failure. In this respect, continued Western assistance, both financial and intellectual, is critical to the success of the privatization enterprise. The West should not view its necessary financial assistance in terms of traditional developmental aid—investments in large-scale projects that have tended only to distort the market-allocation process—but rather in terms of a subsidy to help pay for the transitional costs, such as those connected with labor adjustment, and with the social safety net, which are necessary for a shift to a market economy. With respect to technical assistance and advice, theoretical lessons on the functioning of the markets and the formal training of manager-entrepreneurs may ultimately be of secondary importance. Far more crucial at the present juncture is an understanding of how governments can cope with the dislocation costs involved in the transition to a market economy, and the various normative claims and asserted interests of stakeholders, without jeopardizing political stability, social order, or the definite commitment to the market system. How the West responds to these challenges will say as much about its core values and aspirations as it will those of the East.