

Carnegie Council Privatization Project

The Various Roads to a Private Economy



Dr. Leszek Balcerowicz
Former Finance Minister and Deputy
Prime Minister of Poland



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Dr. Leszek Balcerowicz

The title of my talk, "The Various Roads to a Private Economy," obliges me to make a couple of general points about privatization and precludes my being too Poland-centric, although I will include Poland in the picture. Let me start with a general distinction which I find useful in discussing the privatization process, and this is the distinction between the general regime of property rights and the legal form of an enterprise. Both are important for privatization. As far as the general regime of property rights is concerned, until recently we had to make do with two basic types: restrictive and liberal. A restrictive general regime of property rights existed in the socialist countries; private enterprise was usually banned or very much restricted and only one form of enterprise was promoted. This

was either state property as in the former Soviet Union and other countries, or self-management enterprise, as in Yugoslavia. In the West, on the other hand, you have a liberal regime of property rights whereby a potential investor may choose many various forms of enterprise. He may choose amongst a cooperative, a partnership, or a limited liability company; there are various private enterprise forms. Having the free choice of a form of enterprise, the overwhelming majority of investors choose private property, although, for example, cooperatives are not banned. This is why, whenever you have a liberal regime of property rights and whenever the state is not nationalizing private enterprises, the ownership structure is characterized by the dominance of various private firms. One very important form of privatization which happened in some countries, especially in the socialist ones, was a shift from a restrictive regime of property rights to a liberal regime of property rights, which is

to say that the bans and restrictions of private property were lifted. This gave rise to spontaneous growth of the private sector. A general regime of property rights should be distinguished from the legal form of particular firms, and here I would note that it's not always obvious what a private firm is. There is little problem with a classical private firm which was owner-managed, but the further we move away from this classical capitalistic enterprise, the more problems we have with definition and also the more problems we have in saying why a large outsider-controlled private enterprise is

superior to other forms of enterprise. It is certainly much more difficult to prove the superiority of large modern corporations over state enterprises than it is to prove why a classic owner-managed enterprise is an

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efficient form. Given this, it is advisable in the early stages of privatization to create as favorable conditions for the development of this particular form of private enterprise as possible, because other forms of private enterprise may not be as efficient. Indeed, there is discussion amongst economists as to what extent firms controlled by outsiders operating in the capital market are better than those under state supervision. I would maintain that the former is better, but it is not as obvious as is the case with classical owner-managed firms.

Another general point is how should we understand privatization? I would draw your attention to the fact that it's useful to start with the very wide concept of privatization, because then we do not lose sight of some very important processes. The widest possible concept of privatization is an increase in the share of assets which are under the control of the private sector, conventionally defined. If we define privatization in such a way, then we see that there are



Dr. Balcerowicz (right) greeting Dr. Jerzy Surdykowski, consul general of Poland.

many important processes which lead to privatization. The first process is the spontaneous growth of the private sector; it is a very important process in privatizing a whole economy. The second process is the privatizing of state, public or municipal enterprises, and this process can be executed in various ways. On the one hand, one can transform existing state enterprises by public offers, private placement of shares, or by some other privatization techniques, thus reducing the number of public enterprises. But you may also privatize without reducing the number of state firms, i.e., by shifting assets. In this case, the number of state firms remains the same, but their assets are shifted—by leasing, selling, and other techniques. This asset-privatization has proved, in some countries such as Poland, to be a very important process of privatization.

The important point is what determines the importance of the respective privatization processes. I would argue that their relative importance depends not only on the privatization program, narrowly defined, but depends on the nature of the total economic program. For example, if a tough and comprehensive stabilization and liberalization program is introduced, as in Poland, it turns out to be a very important factor of privatization, because, among other things, it induces state firms to get rid of unnecessary assets. This is due to the new financial pressure and not to the elimination of a shortage economy. So I think this is an important general point: when discussing privatization one should not look only at the privatization

component of an economic program, one should look at the total program, which could be conventionally broken down into macroeconomic stabilization, macroeconomic liberalization, and fundamental institutional change—including transforming inherited state enterprises into some kind of private form.

Before I discuss privatization processes in post-socialist economies, let me try to provide a general look at privatization processes in the world. In such a way we see more clearly the differences and specificities of privatization processes in the post-socialist countries. At the risk of oversimplification, I would say that three types of privatization programs have emerged, depending on the initial regime of property rights, its share of state ownership, and the development of the capital market. The first type of program is prevalent in the OECD countries and some more developed LDCs such as Argentina and Mexico. Here, the public sector is in the minority, and on the whole there are rather well-developed capital markets. So privatization does not require much change in the general regime of property rights except perhaps for liberalization of foreign trade, as in the case of Argentina or Mexico. But the thrust of the program is in transforming the state enterprises by conventional techniques of selling them publicly or privately, and these techniques work because there are well-developed capital markets and the public sector is a minority.

The second type of program is represented by most of the remaining developing countries. Here again the public sector is a minority, but on the whole its share is larger, and the general regime of property rights is often unclear. Ferdinand de Soto of Peru, in a Carnegie Council Privatization Project report, stressed the importance of change in the general regime of property rights—not so

“It is by no means proven that fast privatization induces more unemployment than slow privatization; it may only be a difference in time. If you take a sufficiently long look, you see that under slow privatization you preserve a lot of hidden unemployment and then you either return to a kind of socialist economy, with related inefficiency, or you have a sudden surge of unemployment. Fast privatization may induce a more uniform growth of unemployment.”

much content, but enforcement, which depends on the existence of clear property entitlements. This change in property rights can be very important in changing the operations of people and of enterprises. Therefore, as distinct from the first group of countries, there is more need for a change in the general nature of property rights. However, since the public sector is in a minority, there is not much need for

unconventional privatization techniques (e.g., use of privatization vouchers substituting for the sale of enterprises).

We then come to the third kind of program, which is typical for socialist countries. What was the inherited situation? First, there was a restrictive regime of property rights, whereby private enterprises were banned or very limited in their creation and development. So one obvious point was to change this regime, and to switch from a restrictive to a liberal regime of property rights. Second, the share of the public sector was much larger than was the case in the OECD countries or in developing countries. In the socialist countries, typically 80 percent of GDP was in the public sector. So, if one decided to privatize fast, the question was, is it possible to do so by conventional techniques of public or private placement if one did not have at one's disposal a huge apparatus such as the Treuhandanstalt in East Germany? (Which, by the way, should be treated as an exception and

“The basic structure was the following: to try to launch, as soon as possible, a comprehensive program which consisted of tough macroeconomic stabilization and comprehensive liberalization, and also to start fundamental institutional change like the privatization of enterprises and tax reform. So the essence of the program was that you had to stabilize and liberalize an economy which was still socialist.”

not as a rule.) A third feature of the initial situation in post-socialist countries was the fact that the public sector existed for a number of years and for many years people were subject to a kind of propaganda that these enterprises were commonly owned, which led to the perception among workers that they had certain *de facto* entitlements to the property. So one of the problems was what to do with this psychological, and to some extent political, state of affairs.

I would like now to make some points about privatization in post-socialist countries against this background. It is important to remember that while they shared these common features, there were also some important differences in points of departure.

First, there were sharp differences in the degree of macroeconomic instability at the beginning. On the one hand there was Poland in 1989, plagued by massive shortages and struck by the macroeconomic catastrophe of hyperinflation with prices rising 40 percent per month and a black market rate of exchange to the dollar eight times as high as the official one. This, of course, put enormous pressure upon quick stabilization of the economy. On the other hand there was the former Czechoslovakia with an inflation rate of less than 10 percent annually and few shortages.

Second, there were different degrees of elements of the market economy. On the one hand there were rigid, centralized, centrally planned economies, such as in the Soviet Union, Czechoslovakia, Bulgaria, and Romania. On the other hand there were countries with some elements of a market economy, such as Hungary, the former Yugoslavia, and Poland, and with the benefit of hindsight one can wonder whether this was a blessing or whether it was a burden. One by-product of these elements of a market economy was reduced central control, which made it difficult to control the privatization process. The enterprises somehow acquired veto power in the subsequent privatization process by virtue of the previous elements of the socialist market economy.

The third difference in the point of departure in these post-socialist economies, and in my opinion an extremely important one, refers to the economic structure or sector composition of the economy. Here a contrast should be drawn

between, say, China or Vietnam—with large and easily privatizable agriculture—and the industrialized socialist countries. Both China and Vietnam were underdeveloped countries, while the socialist countries were relatively industrialized; they had a higher share of socialist industry in their structure. Most of the industrialized economies had collectivized agriculture as well, but of a different nature than the Chinese, and not so easily privatizable.

The Chinese point of departure was much more favorable for privatization and for the entire economic reform process than the others. This was not due to special characteristics of the Chinese, but to their history. They had an underdeveloped, agriculture-dominated economy and by dismantling the nonsensical communes which were established by Mao Tse-tung, they could achieve a very rapid pace of *de facto* privatization. Of course, they did not call it privatization at the time; in the late 1970s they called it the introduction of a “responsibility” system. But, disregarding the name, this was *de facto* privatization. The general point, therefore, is that those socialist countries which were underdeveloped and therefore had a large share of easily privatizable agriculture had certain advantages, compared to more developed socialist economies, because the more developed socialist economies were also the more distorted. The longer the socialist system existed, the more distortion you had in both the economic structure and the size of enterprises, because one of the predilections of socialist central planners was to build large enterprises and large plants. So you can see there were various important differences in the initial situation, with implications for the privatization process.

The second point, and here I would like to return to a

point I made already, is that the subsequent pace of privatization depended not only on the initial conditions, but also on the whole nature of the economic program. Let me be more specific, and here I will talk more about

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Poland. In Poland, an important role in the privatization process was played by stabilization and comprehensive liberalization. Until now these were the most important factors in the privatization of the Polish economy. Why? First, because stabilization and comprehensive liberalization included lifting restrictions on setting up and developing private enterprise, and, as a result, you got very fast spontaneous growth. A general point is that in every country you always have a sufficient supply of entrepreneurs. Culture does not matter. In Africa, Europe, and Asia, if you do not have private entrepreneurs, it is not because they do not exist; it is because of institutional constraints. Entrepreneurs respond whenever you lift restrictions. One can say that the private market economy is a natural state of society. By introducing a radical liberalization program, you make it possible for private enterprises to engage in foreign trade, and foreign trade in itself is an important activity. If the private sector can import, it’s less dependent on the monopolistic state enterprise, so it can develop more autonomously.

Third, by introducing a tough stabilization and liberalization program, enterprises are subjected to a new phenomenon, which they strongly dislike. They call it a demand barrier, which means “no shortage” economy; you cannot sell everything. They are subject to the normal kind of financial pressures and, being subject to these pressures, they look at their assets and discover that many are unnecessary and they try to sell or lease them, usually to the private sector. In this way the stabilization and liberalization program sets in motion a powerful asset privatization, whereby the number of state enterprises is not reduced, but the number of assets controlled by those enterprises is, and you get a spontaneous growth of the private sector.

The fourth point is that tough stabilization and liberalization removes, in a radical way, the shortage economy, and by removing the shortage economy it also provides a new situation. Under the shortage economy, state enterprises always needed extra assets: more trucks and more warehouses, because they were never certain of their suppli-

ers. If you introduce a normal market economy, these assets are not necessary, and the enterprises are willing or forced to get rid of them and shift them to the private sector. So, I repeat, a stabilization and liberalization program is an important factor in privatizing the economy and this has been shown in Poland, as well as in some other countries.

One of the most discussed issues in privatization is the desirable pace. In discussing this issue, I should distinguish between spontaneous growth of the private sector on the one hand, and privatizing inherited state enterprises on the other hand. With respect to the first component of privatization, there is not much dispute that the growth of the private sector should be as fast as possible. There is more disagreement with regard to the second process, which is privatization proper. Some people say that you should aim at a medium pace, not too fast, because if you aim at very fast privatization you create enormous unemployment. I think this is the most serious argument against fast privatization, and with respect to that I would make two points. First, it is by no means proven that fast privatization induces more unemployment than slow privatization; it may only be a difference in time. If you take a sufficiently long look, you see that under slow privatization you preserve a lot of hidden unemployment and then you either return to a kind of socialist economy, with related inefficiency, or you have a sudden surge of unemployment. Fast privatization may induce a more uniform growth of unemployment. So there is a different time profile, but the end situations may not differ very much. The second argument, which in my mind tilts the balance for fast privatization and against slow privatization, is the following: there is a certain critical size of the public sector in the



At a breakfast in Dr. Balcerowicz's honor are (from left to right) Rick Dowden, Volvo North America Corporation; Dr. Balcerowicz; Shafiqul Islam, Council on Foreign Relations; and Martin Blumenthal, Techint, Inc.

economy which, if exceeded, leads unavoidably to politicizing of the economy. So if you have, for example, 10 percent of the population employed in the public sector, then the danger of politicization is much less than if 40 percent or 50 percent is in the public sector. At that high a percentage, the political pressures coming from the public sector—which, after all, is a political sector because owners are political bodies—

are probably unavoidable. Even if you manage to reduce the political pressures, they may return after a while, and if the economy is politicized, efficiency is lost. In my mind, one should try to get as fast as possible under that threshold of public sector employment which, if exceeded, leads to the politicizing of the economy. ■

Questions and Answers

Q Do you have any comments on privatization efforts in the United States?

A I do not have independent observations. My observations are partly drawn from the interesting discussions that took place here, through the Carnegie Council Privatization Project, and the papers which resulted. They have made an interesting point—that privatization is not so much an issue at the federal level, but it is quite an issue at the local and state levels. If a local government controls lots of assets, like in New York, and it has millions of people, there is not much difference between this and a socialist economy. You've got the typical phenomena of the public sector: restrictive labor practices and trade unions. I skipped the whole issue of the effects of privatization, but I would like to add one comment: the effects should be considered in analyzing not only the product market, where a given firm is operated, but also the labor market. Especially in socialist economies, privatization of a once-vast public economy is probably the most efficient way of introducing a competitive labor market and reducing the influence of aggressive trade unions. This is not only the case in socialist economies, it's the case in local governments in the United States.

Q I'd like to get your views on the recent change of government in Poland and its impact on the pace and the nature of privatization there, particularly privatization by liquidation.

A In every change of government in a democratic country you have to distinguish between change in rhetoric and change in substance. Usually the change in rhetoric is much more than the change in substance. The new government in Poland has to some extent introduced a new rhetoric, but it's not a rhetoric of radical departure. They are trying to gain some popularity by saying that the public sector was discriminated against, and that there should be more

protection. This is unfortunate, because one should not only be tough with regard to the public sector, one should *talk* tough to all the people. Words in politics are deeds, because in politics words influence expectations—mass expectations—and mass expectation may change mass behavior. Still, as far as the changes in substance in this new government are concerned, my guess would be that they are probably going to be minor, if there are going to be any at all. There are three tests: first is the budget, which is the key to stability. The second test is privatization. Here, the new government will try to launch the programs which are already prepared, such as the so-called mass privatization program, which is not really mass privatization, but substantial privatization. Another program is related to the restructuring of the banks and state enterprises. This is a very important program and I think it's going to be launched with the participation of the EBRD. There is also what is called in Poland a "social pact," which includes some inducements to the workers to make them more willing to accept the privatization of their companies.

The third test is trade policy, and I see certain dangers here. The one danger is on the protectionist side, especially because the second largest party in the government is the Peasant Party, which may try, unfortunately, to emulate the harmful agricultural policies which prevail in the West.

Q How would you respond to an argument that the result of the last election in Poland was somewhat a failure of the Balcerowicz Plan and the Balcerowicz transformation of the Polish economy?

A Many observers made two points. First, that the election outcome was solely or mainly due to a radical economic program and second, that such a program should therefore be rejected. I think both these statements are wrong. Let me take the first one.

In Poland, the outcome of the election was due to a combination of factors. To some extent it *was*

under a very difficult situation, there is no way of avoiding risk. But the choice is very easy, intellectually speaking, because on the one hand you have a very risky program, a radical one; and on the other hand you have an almost hopeless program, and you should always prefer a risky option to a hopeless one. This is why the choice was not very difficult, intellectually speaking.

I would add that there are certain things, with the benefit of hindsight, that I would have done differently, although I am not quite sure even now about their success. First, I would certainly pay more attention to the problem of the pension system. The expenditures of pension exploded, mostly because of

indexation, and because of the growing number of pensioners. It was too easy to get a pension. Second, it would be very useful if this unconventional privatization was started earlier, in 1990 and 1991, because the political conditions were better then. I am not quite sure, even now, if it was possible, though. In Poland in 1991 we had elections, and it turned out to be extremely difficult to introduce certain strategic pieces of legislation in the parliament just before the elections. But given subsequent developments, it would have been better to launch massive privatization as early as possible, to create a group of people whose interests were in preserving privatization and in launching further privatizations.

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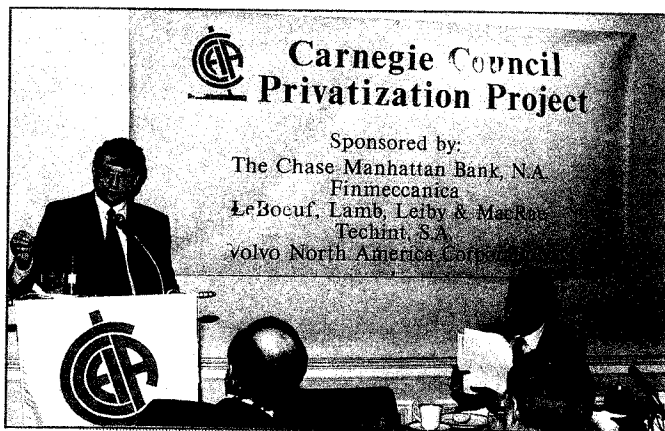
due to the economic program, which doesn't say that under a different economic program the degree of dissatisfaction would have been less. If you start in an extremely difficult economic situation, whatever you do, you are going to have a sizable proportion of people who are dissatisfied. The point is to gain, in the process, some economic benefits. If you introduce a radical economic program, some people become unemployed—and not on the job, but openly, at home. Certainly it's more pleasant to be unemployed on the job than at home. Second, if you introduce a successful economic program, then some people are going to go up in relative terms—new entrepreneurs, good accountants, good managers, etc.—but at the same time, other people are going to go down in relative terms, and the second category of people rather dislike it, which is human. This is all strengthened by a shift which is due not to economic, but to political, liberation. There is a shift in the mass media from engaging in what in Poland was called “the propaganda of success” (under a dictatorship you've got a propaganda of success, which is to say that only positive phenomena are reported and negative ones are disregarded) to “the propaganda of failure,” which is typical of free mass media, focusing on the negative and the sensational. In the post-socialist countries, therefore, you had a shift from a lack of criticism to extreme criticism and many people confuse an increase in visibility of negative phenomena with a true growth of this phenomena. This combination of economic liberalization and political liberalization probably contributed to the election results. But economic factors were not the only ones. There were some other factors in Poland which made the outcome so negative for the

parties in the previous government. First, the parties in the previous government went to the elections separately instead of going together, and in this way they lost because we've got a new, improved electoral law which favors larger groupings of parties. Second, there were some noneconomic issues involved in the elections, such as abortion and the influence of the church in public life, and these were unpopular among most Poles, so parties which criticized these things, gained.

Now the second point. Even if to some extent election results are due to a radical economic program started under extremely unfavorable conditions, it is wrong to conclude that you have to reject them, because by rejecting one option you are choosing some other options. So one should always compare the degree of dissatisfaction under different economic programs, but also the degree of satisfaction and the economic benefits. If such a comparison is made for the same initial conditions and the same external conditions, I have no doubt that even if you become less popular by launching a radical economic program it's better for the people, and it's also better to start such a program very early and very rapidly.

Q If you were to restart the restructuring process of the Polish economy, what would you do differently, given the present situation in Poland?

A I would not change anything in the basic structure of the program. The basic structure was the following: to try to launch, as soon as possible, a comprehensive program which consisted of tough macroeconomic stabilization and comprehensive liberalization, and also to start fundamental institutional changes like the privatization of enterprises and tax reform. So the essence of the program was that you had to stabilize and liberalize an economy which was still socialist. In the second stage, while the institutional changes continue, you change the institutional nature of the economy. This was the essence of the radical program, and I wouldn't change it because, when I compare this with alternative programs of delayed stabilization, I see the Russian example. If I compare it with limited liberalization, I also see Russia and many other countries of the former Soviet Union, and I see the differences in performance. If I look for neglected stabilization and very modest liberalization, I see Ukraine. So, by making suitable comparisons, you see that this program, although risky, was the safest one. By the way, when you start the transition



Dr. Balcerowicz speaking at a Privatization Project breakfast