Privatizing the Czech Republic

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Source: *World Policy Journal*, Fall, 1995, Vol. 12, No. 3 (Fall, 1995), pp. 124-128

Published by: Duke University Press

Stable URL: https://www.jstor.org/stable/40209438

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Privatization, like other key aspects of the transition to market economies in central and eastern Europe, has no precedent in the history of modern economies—at least not on the scale that is now being attempted. The architects of privatization have had to develop programs for transferring state-owned enterprises to the private sector and establishing a new system of property rights without the benefit of reliable working models to guide them.

When privatization in the former communist states began in 1989, the only prior large-scale experience with privatization had occurred in Great Britain under Margaret Thatcher. The British model, however, had a number of shortcomings with respect to central and eastern Europe.

The process was slow, often costly, and designed for a very limited objective, the sale of a range of publicly held assets and state enterprises to an already existing private sector. In Great Britain, there was no need to create a stock exchange, an independent central bank, genuine trade unions, or any of the other institutions of a market economy, since these institutions were already firmly in place. Britain had a fully developed class structure, whereas in the former communist states, a new class of owners—a bourgeoisie—needed to be created by the transfer of ownership of economic resources from the state to a nascent private sector.

Despite these fundamental differences, Hungary, Poland, Estonia, and the former German Democratic Republic (GDR) attempted to follow the British example. Success has been limited in the first three countries, where privatization entailed selling several dozen state-owned companies. Only a portion of those enterprises slated for privatization have been sold. The former GDR is the exception, since unification with the Federal Republic of Germany brought with it the transfer of developed market institutions as well as large amounts of financial assistance.

Privatization Options

There were, of course, a number of other options available to the former communist states. The most obvious was reprivatization, or returning nationalized properties to their original owners. The Czech Republic's technocratic reformers were at first opposed to reprivatization; they feared it would bring with it complicated and lengthy legal challenges, which would delay the reform process. But popular demand for some form of restitution led them to adopt a plan for reprivatizating small businesses and housing in 1990. Since then, tens of thousands of houses, shops, restaurants, workshops, small factories, service facilities, and parcels of land have been returned to the original owners or their heirs. However, the Czech reprivatization plan did not affect small businesses that were confiscated prior to February 25, 1948 (the date of the communist coup d'état), or large industrial enterprises, since they were nationalized before the cutoff date.

To solve the problem of privatizing large industrial enterprises, the Czech privatization architects came up with a new concept: free, or nearly free, distribution of property. They considered two groups as potential recipients of the privatized properties: the employees of the companies designated for privatization and the general citizenry.

Employee ownership is supposed to have one major advantage: insiders—who, in effect, hold quasi property rights in a firm prior to its privatization—are given an incentive to cooperate in the privatization process. This method was followed in Russia, where shares were distributed based on an employee's rank in the company being privatized, with top management receiving the largest number of shares. However, turning ownership over to company employees has two major disadvantages. First, it is unfair to outsiders—pensioners, civil servants, and workers at companies not designated for privatization. Second, the efficiency of employee-owned or -managed companies is questionable under normal conditions and could prove particularly problematic in eastern Europe and the former Soviet Union, where most companies are in need of massive restructuring, especially labor force reduction.

For these reasons, the architects of Czech privatization chose to distribute property among the population as a whole, using a voucher system. Although such a system is potentially cumbersome and complicated, the Czech Republic was largely able to avoid this disadvantage. Indeed, the greatest achievement of the Czech reformers was the creation of a scheme that was effective and expedient.

The Czech process proceeded in two stages. In the first stage, the acting minister of privatization, Tomáš Jezek, devised a plan using vouchers to create joint stock companies. The management of each company designated for privatization was required to prepare a basic privatization proposal. These were evaluated by the Ministry of Privatization against competing proposals, which could be submitted by anyone, domestic or foreign. The competitive element was a key feature and safeguard of the Czech plan because it ensured companies' cooperation. If managers did not come up with a viable plan to privatize their companies, they would risk having someone else's plan imposed on them. In the second stage, the vouchers were distributed by auction, following a plan devised by Dušan Tríska. Václav Klaus, former finance minister of Czechoslovakia and now prime minister of the Czech Republic, delivered critical political backing for the process, without which it would not have been implemented.

The first wave was completed in June 1993 and the second in March 1995. At the end of the first wave, the private sector accounted for more than 50 percent of Czech GDP. By the end of 1995, after the second wave, it is estimated that the private sector will account for approximately 70–80 percent of GDP.

Czech Goals

The Czech privatization process had four goals: First, to improve economic efficiency on the micro level, so that companies would be more profitable. Second, to improve economic efficiency in the larger macro sense, that is, by creating the entire system of a market economy, including a class of owners, so that resources are allocated more efficiently. Third, to build political support for the whole process of political and economic transformation. Fourth, to create a system of private property rights, as a necessary, albeit not solely sufficient, condition for achieving genuine democracy and ensuring personal liberties.

To achieve economic efficiency on the micro level, immediate capital investment, technological know-how, and secure product markets are needed. In the early stages of transformation, capital and technology came predominantly from foreigners, which would seem to suggest a privatization strategy aimed at encouraging foreign direct investment. But looking at the problem within the broader political framework, the goal is not only to increase economic efficiency in a narrow sense but also to create a constituency that will provide political and social stability during the transformation and sustain economic reform afterward.

The best way to build such a pro-market constituency is to create a broad class of owners (or a large middle class) who have an intrinsic interest in maintaining a stable regime of private property rights. To create this constituency, support must be given to the domestic entrepreneur, but this is not a simple task. The development of an entrepreneurial class will come slowly, since domestic capital and technological know-how are scant, but in the long term, policies that support the development of a large middle class will eventually pay off in terms of both political stability and sustained economic growth.

Creating a Middle Class

In the Czech Republic, the development of a middle class has been relatively straightforward, since the petite bourgeoisie and intellectuals made up a large portion of the population before the Communists took over. Restitution and small-scale privatization policies, along with efforts to start up businesses from scratch, have largely restored the petite bourgeoisie in Czech society. Restitution created hundreds of thousands of owners of significant properties virtually overnight. Opponents of restitution argued that there was no reason to believe that entrepreneurial abilities are inherited, or that the children and grandchildren of the old entrepreneurial classes would be competent business owners. However, they failed to consider the role of the secondary market. In cases where new owners did not inherit entrepreneurial abilities, they either sold, leased, or lost restituted properties to those who could administer them more competently. This Darwinian selection by the market has worked fairly well, at least on the level of small companies.

Clearly, the existence of the petite bourgeoisie made it easier for the Czech Republic to create a strong middle class. But it would be a mistake to conclude that this alone was the decisive factor in the Czech success. The economic and social conditions were also right. Compare the Czech Republic's situation with Russia's. Although Russia is richly endowed with natural resources, having raw materials (such as oil, gas, or basic metals) as a primary source of income does not augur well for the creation of a middle class, since these materials can easily be monopolized. There is a good chance that a society with such an endowment will develop along the lines of Latin America, in which a small segment of the population controls most of the wealth. This appears to be happening in Russia. The risk of social conflict where this occurs is much higher than in a society with a strong middle class. Conversely, a society dependent on manufacturing and services for income, such as the Czech Republic, has a much greater chance of developing a strong middle class and is less susceptible to social conflict.

Voucher privatization gave the Czech citizenry a stake in the transformation of the economy. In this respect, the privatization plan was a major success. What it did not promote, however, was the active participation of the new owners in the corporate governance of privatized companies. Consequently, the majority of these companies will require a second "privatization" in order to concentrate property in the hands of "real" owners. This, of course, may occur at the expense of small shareholders. But for now, voucher privatization is perceived as a success precisely because it delivered the mass political support necessary to sustain stability during a very difficult economic and political period.

Finally, privatization has established the basic protection of personal liberties. Paradoxically, the people who first benefited from this protection were former *nomenklatura*. Some of them were fired soon after the

1989 "Velvet Revolution" and had trouble finding new jobs, but the emergence of a private sector gave them the chance to either find employment there or establish their own businesses.

Under the so-called lustration (de-communization) law, former Communist Party *apparatchiks* and secret police collaborators were prevented from holding leading positions in the civil service and in state-owned enterprises. This provided an added stimulus for privatization by pushing members of these groups into the private sector. Thus, the institution of private property has constituted a basic protection against mistreatment of groups out of favor with the current government.

Other Experiments

The success of Czech voucher privatization is unique. Other former communist countries' experiments with privatization have been less successful. In Poland, where voucher privatization was first attempted, political infighting, most recently between the government and President Lech Walesa, delayed its implementation. An agreement was reached this past July on the details of the program and the number of public firms to be privatized in this fashion, but it may yet be scuttled. In contrast to the Czech method, the Polish plan calls for the distribution of blocks of shares to centrally established investment funds, which will then sell certificates to individuals for a small sum. Western experts are involved in the management of these funds.

In Hungary, the state has focused on selling off as many state-owned enterprises as possible as a means of generating revenue. Most buyers have been foreign corporations, and they have expressed interest in only a limited number of the companies up for sale. Thus, the question arises of what to do with the rest. A program of general auctions and sales to employees is being discussed.

In Slovakia, the first wave of voucher privatization was conducted in the same way as in the Czech Republic, since Slovakia participated in the program in the former Czechoslovakia. After the division of the country in 1993, however, the Slovak government of Vladimir Meciar denounced the program and sought more conventional methods of privatization. After the fall of the Meciar government in March 1994, a second wave of privatization was initiated by the interim government. In September 1994, however, Meciar regained power and began a new campaign against voucher privatization. His government was able to postpone the start of the second wave until this past July, when a proposal to do away with the voucher system altogether was passed by the Slovak Parliament.

The problem now facing the Slovak government is that most of the population supports voucher privatization. Before July, 3.5 million people had registered with the interim government to participate in the program, a million more than registered before the first wave. Whether these 3.5 million people will be satisfied with the Meciar government's alternative plan—to distribute five-year interest-bearing bonds instead of voucher property rights—remains to be seen.

Romania experimented with a mass privatization strategy involving the use of five centrally established investment funds. The plan was that these funds would control 30 percent of the shares in privatizing companies. Each subsequent year, an additional 10 percent would be distributed. Now, however, the program is in effect frozen, and all of the funds have degenerated into branches of government ministries.

The most interesting privatization program is the one introduced in Russia, which consists of employee-ownership and a voucher program. Under this plan, employees of enterprises designated for privatization were entitled to buy up to 40 percent or, in some instances, as much as 51 percent of the shares in their companies. A further 20–25 percent was auctioned off using vouchers. This combination of voucher and employee privatization produced a rapid transition in the Russian economy. The crucial question now is how the secondary market will operate. If investment funds are to have the means to exert influence on companies, as in the Czech Republic, they will have to buy out the shares owned by the employees. The ultimate success of the Russian road to privatization depends on the speed with which this can be carried out.

The success of Czech voucher privatization has generated a great deal of interest among policymakers in other countries. A similar scheme, developed in collaboration with the Czech architects of voucher privatization, is currently under consideration in Kazakhstan. Bulgaria is also considering the Czech model, and it may be the means of defrosting the privatization process in Romania. Slovenia has also borrowed from Czech voucher privatization. The World Bank, once a major critic of the Czech method, now supports its introduction elsewhere.

What Can Be Learned

While the privatization process is not yet complete in the Czech Republic, we can draw some lessons from the Czech experience. To achieve political stability and major economic reforms, it was necessary to create a broad base of support. The most supportive constituency comprises those who directly benefit from the process, above all, owners of houses, land, and small businesses obtained through restitution or privatization and domestic entrepreneurs who have built companies from scratch. In the Czech Republic, which has a labor force of five million, a million people are registered as small business owners.

The role of voucher privatization was, in this respect, secondary. Nevertheless, voucher privatization delivered badly needed overall support for economic transformation and helped to create the necessary conditions for the future development of the Czech economy. Six million people took part in the process and became owners. Furthermore, voucher privatization reduced the volume of corruption that is usually connected with privatization.

Although Czech voucher privatization was not entirely free of scandal, it is plausible that without vouchers the volume of corruption would have been much greater and the level of social support for privatization much lower. Thus, the Czech Republic was able to avoid one of the principal sources of the backlash against the transformation process that occurred everywhere else in central and eastern Europe—namely, the perception that privatization is unfair and riddled with corruption. In all these respects, voucher privatization is clearly an important instrument for both promoting economic development and creating political stability.●