On the Privatization of “Stolen Goods” in Central and Eastern Europe

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After many decades of economic deprivation and political oppression, socialist regimes in the countries of central and eastern Europe (hereafter C&EE) withered away by the end of 1980s. The end of socialism created an opportunity for people in these countries to develop better institutions. Indeed, new leaders in the region immediately announced plans for institutional restructuring. In the early 1990s, most citizens seemed willing to bear the cost of transition, and free-market ideas enjoyed significant political capital.

The West wasted no time in joining the process of transition in C&EE. As one might have predicted, Western governments, Western “transition experts,” international organizations, and more recently the European Union have had significant influence on the scope and patterns of institutional restructuring in C&EE. The World Bank and the International Monetary Fund assumed that controlling institutional changes was their birthright. With the exception of the Czech Republic and Estonia, where Vaclav Klaus and Mart Laar, respectively, initiated “home-grown” free-market reforms, most countries in the region were not left alone to seek and implement their own institutional arrangements. Katharina Pistor found, for example, that the corporate laws developed in various parts of the region resemble those of the countries offering legal assistance. She observes that “the strong similarities of laws that were

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influenced by identifiable groups of foreign advisors suggest that the contents of legal rules . . . were strongly influenced by the group of advisors that dominated in a given country" (2000, 27).

The most oft-repeated message coming from the West in the early 1990s was "privatize, privatize, privatize." Indeed, privatization has been the key policy in post-socialist C&EE. By early 2000, the private sector, consisting primarily of new private (never state-owned) enterprises and privatized state-owned firms, was responsible for more than half of the gross domestic product (GDP) in C&EE, ranging from 80 percent in Hungary to 20 percent in Belarus (Mitra et al. 2000, 6). The consensus is that the new privatize enterprises, which are not the subject of my analysis here, have been the most important contributing factor to this growing share of the private sector (Dabrowski 2002; Laki 2002; Winiecki 2002).

In this article, I analyze the contribution of the privatization of state-owned firms to the institutional restructuring of C&EE. My key finding is that instead of reducing the transaction costs of moving privatized assets to their highest-valued users, the privatization of state-owned firms has slowed down institutional restructuring in C&EE. This relative failure of the privatization of state-owned firms can be attributed to three factors: the influence of neoclassical economics, the absence of decommunization, and the unwillingness of the new elite in the region to recognize and enforce the right of ownership in state-owned assets.

Privatization and Institutional Restructuring

To provide background for the analysis, in this section I briefly identify the major objective of the process of transition in C&EE and some of its most important features.

The transformation of the C&EE countries' socialist economies into capitalist—or free-market, private-property—economies was the new leaders' major stated objective in the early 1990s.[1] Conceptually, genuine capitalism is institutionalized as prescribed by the doctrines of classical liberalism. Its main traits are the rule of law, constitutional democracy, and open markets.[2] The rule of law, which the constitution embodies, guarantees stability and credibility of private-property rights, contractual freedom, and an independent judiciary. Those institutions, often seen as guarantors of so-called *negative rights,* protect individual members of the community from being forced by a majority rule, decision makers in government, labor unions, and other

1. I use the terms *capitalism* and the *free-market economy* interchangeably in this article. Although some leaders in C&EE believed in the transformation to capitalism, others misunderstood the implications (costs) of capitalism, and still others merely paid lip service to the transition to capitalism in order to please the West and local free-market parties.

2. The *rule of law* means absence of arbitrary power on the part of the ruling group; subjection of all citizens to the same laws; stable and credible rules; and democratic elections. The absence of discretionary power means that no rule is to be enacted with the intent of helping or harming particular individuals. See Leoni 1961.

rent-seeking groups to subordinate the pursuits of their private ends to a desired outcome. James M. Buchanan observes: "[In a rule-of-law state] there is an explicit prejudice in favor of previously existing rights, not because this structure possesses some intrinsic ethical attributes, and not because change itself is undesirable, but for the much more elementary reason that only such prejudice offers incentives for the emergence of voluntary negotiated settlements among [individual members of the community]" (1972, 451–52). Open markets reflect a network of contractual rights and responsibilities based on the rule of law and constitutional democracy. In a world of bounded rationality, open markets provide freely choosing individuals with strong incentives spontaneously to develop, try, and accept institutional arrangements ("rules of the game") that minimize the transaction costs of voluntarily (1) letting resources find their highest-valued uses and (2) accepting the risk associated with the development (innovation) of new opportunities for exchange. By implication, *the economic efficiency of the use of resources is expressed in the process through which voluntary interactions are carried out, leading into the unknown.*[3] It is not properly to be judged by the attainment of a prestipulated desirable outcome or by its quantitative dimensions.[4] Institutions that offer greater incentives for voluntary interactions are ipso facto more efficient than institutions that provide fewer options for free exchange.

This is not to say that quantitative indices are useless. The point is that quantitative results frequently reflect the consequences of government interference with the freedom to choose (for example, tax breaks for specific investments), and such results are sustainable only as long as that interference lasts. James Gwartney, one of the founders of the Economic Freedom of the World Index, argues that the long-run sustainability of high growth rates depends on how closely a country's institutions conform to the dictates of classical liberalism, not on its government's own efforts to promote growth directly: "The maintenance over a *lengthy period of time* of institutions and policies consistent with economic freedom is a major determinant of cross-country differences in per capita GDP; cross-country differences in the mean rating during 1980–2000 explain 63.2 percent of the cross-country variations in 2000 per capita GDP" (Gwartney and Lawson 2004, 220, emphasis added).

Although the ideal of capitalism based on the rule of law, constitutional democracy, and open markets has never been realized fully in history, it provides a useful blueprint for evaluating a country's prevailing institutions as well as its proposed institutional reforms. I use here the Index of Economic Freedom, published annually by the Heritage Foundation and the *Wall Street Journal* since 1995, as a proxy for evaluating the position of individual countries vis-à-vis genuine capitalism. The score of 1

3. We owe a great intellectual debt to James Buchanan for emphasizing and explaining this point in numerous works.

4. There is no a priori reason for judging a policy that promises 5 percent growth of GDP to be more efficient than a policy that promises a zero percent growth. My freely chosen decision to spend $1,000 on wine and women represents a more efficient use of resources than my being forced (or induced via tax or other incentives) by the state to invest the same $1,000 in a project that promises a 5 percent rate of return.

(the best), which no country receives, represents the attainment of genuine capitalism. The best-ranking country in 2005 is Luxemburg, with the score of 1.65.[5] To rank countries in terms of economic freedom, the index uses the factors that undergird genuine capitalism.[6] The index is not a perfect yardstick for measuring how closely individual countries come to genuine capitalism, but along with the Fraser Institute's Economic Freedom of the World Index, it is the best yardstick we have.

One problem is that the index fails to account for differences in the incentive effects of the various elements that compose it. For example, private-property rights in Germany and the United States score 1 (the highest score). Yet, although their legal credibility might be the same, their incentive effects are not. Property rights in Germany do not protect the subjective preferences of their owners as well as property rights do in the United States. They do not protect private-property owners by obstructing legislative and regulatory redistributive measures to the same degree. German law protects private-property rights only to the extent that they serve "human dignity" (as if free markets were not doing precisely that) and the German welfare state.[7]

According to the 2005 Index of Economic Freedom (Miles, Feulner, and O'Grady 2005) fifteen years after the process of transition began in C&EE, only one country in the region is a *free* country: Estonia. Nine countries are *mostly free* (Lithuania, Latvia, Czech Republic, Slovakia, Hungary, Slovenia, Poland, Bulgaria, and Albania). Seven countries are *mostly unfree* (Croatia, Macedonia, Moldova, Russia, Ukraine, Romania, Bosnia and Herzegovina). Belarus is *repressed,* and Serbia and Montenegro is not rated.

The Role of Neoclassical Economics

At the outset of the economic reforms in the early 1990s, the majority of Western advisors, mostly economists working for international organizations, and the new leaders in C&EE were more familiar with the prevailing mainstream economics—neoclassical economics—than with other methods of economic analysis, such a the New Institutional School, Austrian economics, and public choice. Intentionally or not, the process of transition in general and the privatization of state-owned firms in particular have reflected this familiarity with or adherence to the neoclassical way of thinking. Examples include the so-called Washington consensus, Sachs's "big bang" approach

5. For an evaluation of the Heritage Index of Economic Freedom, see Haan and Sturm 2000.

6. Those factors are: trade policy, fiscal burden, government intervention, monetary policy, capital flow and foreign investments, banking and finance, wages and prices, property rights, regulations, and black-market activity. The Index of Economic Freedom scale runs from 1 (the best) to 5 (the worst), and its creators separate countries into four broad categories of economic freedom: *free* (1.95 or less), *mostly free* (2.00–2.95), *mostly unfree* (3.00–3.95), and *repressed* (4.00 or higher).

7. See Alexander 2003. Property rights in Italy are similarly attenuated. Alberto Mingardi (2005), the president of the Bruno Leoni Institute, notes that the Italian Constitution allows protection of private property only insofar as it serves a social function.

to reforms everywhere, Balcerowicz's "big bang" in Poland, and Mencinger's gradualism in Slovenia.[8]

Neoclassical economics converts the desire for more utility, a basic trait of observed human behavior, into the maximization paradigm and analyzes the economic outcomes of that behavior in a hypothetical world of nonattenuated private ownership and insignificant (or exogenously determined) transaction costs.[9] The maximization paradigm identifies a series of equilibria, which, in turn, are taken to represent the efficient outcome of economic activities they embody.[10] The assumptions of nonattenuated private-property rights in resources and of insignificant transaction costs, however, yield misleading conclusions about the economic performance of countries with different institutional arrangements.[11]

The neoclassical way of thinking explains the so-called holy trinity of the process of transition: macroeconomic stability, privatization, and price liberalization. Institutional restructuring means a purposeful destabilization of the rules of the game in the community. Policies superimposing the objective of macroeconomic stability on institutional restructuring can be explained only by the neoclassical assumptions that either new equilibria are created instantaneously or that government fine-tuning of economic processes is possible. For either assumption to be borne out, we may have to await the Second Coming. The objective of price liberalizations implies the assumption that contracts are enforced and that the incentive effects of different institutional arrangements on individuals' behavior do not matter.[12] Conditions in most C&EE countries do not accord with these assumptions. In the absence of credible private-property rights, privatization cannot be expected to perform its function of moving resources to their highest-valued uses.

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8. For a comprehensive review of the predominantly neoclassical proposals and analyses of transition in the first half of 1990s, see Murrell 1995. It is arguable that by the end of the 1990s the new institutional economics, Austrian economics, and public-choice studies began to replace neoclassical models. See Sunstein 1993, Boettke and Butkevich 2001, Colombatto 2001, and Winiecki 2004.

9. A possible reason why neoclassical economics ignores the incentive effects of different institutions on transaction costs is that institutions have ethical roots, and neoclassical economics claims to be value free.

10. In the real world, however, neoclassical equilibria are at best statements about what the state of affairs would have been if private-property rights were credible, contracts enforced, and transaction costs insignificant. To correct the resulting gap between the expected and observed outcomes has been a convenient excuse for government intervention, or dirigisme.

11. Here is what three well-known neoclassical economists said about the Soviet Union shortly before the country disintegrated from within. Robert Heilbroner and Lester Thurow wrote: "Can economic command significantly compress and accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can. In 1920 Russia was but a minor figure in the economic councils of the world. Today it is a country whose economic achievements bear comparison with those of the United States" (1984, 629). Paul Samuelson said: "It is a vulgar mistake to think that most people in Eastern Europe are miserable. . . . The gap between Western and Eastern living standard[s] may narrow in the future" (1980, 624). And John Kenneth Galbraith (1984), on his return from Russia, claimed that the Soviet economy had made great national progress in recent years.

12. For example, Jim wants to sell his car. Judy offers to pay $1,000 now. Laura is willing to pay $1,500 a year from now. At, say, a 10 percent rate of interest, Laura values the car more, and she gets it. However, if the enforcement of contracts were weak or unreliable, Jim might choose to sell his car to Judy—clearly not an efficient choice.

Observing that privatized firms in general have improved their performance, an International Monetary Fund study concludes that "any privatization is better than none, regardless of whether a stable, competitive environment has been established first or not" (Havrylyshyn and McGettigan 1999, 11). A World Bank publication goes even further in ignoring the incentive effects of private-property rights: "In many ways privatization in the early years was a leap of faith. . . . [T]here was neither great theoretical justification nor hard evidence at the beginning of the 1980s that the performance problem of state enterprises could be altered by change in ownership. Thus, the bulk of privatization before 1992–93 took place in the absence of empirical support" (Kikeri and Nellis 2004, 92). Although these World Bank authors eventually discover "mounting empirical evidence of privatization's benefits" (113), they are quick to remark that "two decades of experience have not settled the debate over how much ownership matters (106).

Still, we have no compelling reason to assume that the numbers showing the growing size of the private sector or the improved performance of privatized firms imply a successful transition from socialism to capitalism. Those numbers tell us only that the same bundle of resources is more productive in private rather than government hands. We have known that fact ever since the days of Adam Smith. If the credibility of private-property rights differed in two countries, those two countries' economic efficiency also would differ, even though the relative sizes of their private sectors might be the same. Hence, the improvements in the productivity of privatized firms say little about those firms' contributions to the success of overall institutional restructuring.

In evaluating the economic efficiency of privatization, the fundamental issue is the development of credible private-property rights and the enforcement of contracts, which, in turn, reduce the transaction costs of moving resources to their highest-valued users. If private-property rights were not credible and the enforcement of contracts remained weak, the transaction costs of moving privatized firms from less productive to more productive users would be high. Here are a few remarks about the credibility of private-property rights and contracts in today's C&EE (references to the Czech Republic and Estonia clearly reflect the influence of Vaclav Klaus and Mart Laar, respectively):

> Property and contractual rights are recognized, but enforcement through *Romanian* courts is difficult.
>
> Protection of property rights in *Russia* is weak.
>
> Based on new evidence of corruption in the judiciary, *Poland's* property rights score is 1 point worse this year.
>
> Protection of property rights is weak in *Ukraine*.
>
> Private property is well protected and contractual agreements are generally secure in the *Czech Republic*.
>
> *Estonia's* judiciary is independent and insulated from government influence. Property rights and contracts are enforced by courts.

The legal system [in *Slovakia*] enforces property and contractual rights, but decisions may take years, thus limiting the utility of courts for dispute resolutions. (all from Miles, Feulner, and O'Grady 2004, 160, 176, 332, 338, 340, 358, 398).

Indeed, as early as 1991 the initial political capital favoring the transition to capitalism began to evaporate. A leader of the market-oriented wing of the old solidarity coalition in Poland said: "The laissez-faire theory has not proven right. We have got to have the state intervention. The question is how deep it should be" (Janas Zbigniev, qtd. in *Dallas Morning News*, August 4, 1991). In 1995, Krasznai and Winiecki remarked: "The number of confused people, convinced that all our economic problems started in 1989 seems to be quite large (246). By the mid-1990s, the role of governments in the C&EE economies began to increase in earnest. Commenting on economic trends in Slovakia, Jan Oravec writes: "We can say that in 1993, the Slovak economy and society were less regulated than in 2003" (2004, 5).

Russian president Vladimir Putin inadvertently provided the best evidence that the rule of law, the credibility of private-property rights, and the enforcement of contracts in the region should have come before the privatization of state-owned firms was initiated. Referring to the purchase of Yukos Oil Company by the wholly state-owned oil company Rosneft, Putin said the acquisition was both legal and done in absolute conformity with market mechanisms.[13]

To conclude this section, a few quotations from Peter Murrell's 1995 review article on transition confirm that the neoclassical way of thinking is ill-suited for guiding the process of institutional restructuring. Note first the observations on neoclassical prescriptions for reform: "According to Stanley Fisher, the standard reform prescription for an ex-socialist country is to proceed as fast as possible on macroeconomic stabilization, the liberalization of domestic trade and prices, current account convertibility, privatization, and the creation of a social safety net, while *simultaneously* creating the legal framework for the market economy.... Lawrence Summers perceives economists as showing a striking degree of unanimity on this advice to the reforming countries" (164, emphasis added). Then comes an implicit assumption that informal institutions and habits acquired during the socialist years (and earlier) do not count: "There is great faith in the power of economic knowledge, exemplified by Fisher's characterization of the Russians as fortunate in... trying to return to a system that is well understood in the rest of the world" (173). Finally, we have disappointment with the results: "There seems to have been overoptimism at the onset of the program about the speed of the supply response and other behavioral responses" (174), and "The nonfulfillment of expectations is certainly a persistent element... somewhat troubling when viewed against the backdrop of perceived unanimity on dramatic reform programs" (174).

13. Putin's statement comes from an Associated Press dispatch , December 23, 2004, available at: http://www.rferl.org/featuresarticle/2004/12/e9671558-8078-4725-87b0-2a944347b37d.html.

Without denying neoclassical economics' unique and indispensable contributions to our understanding of the working of the free-market, private-property economy, we must recognize that such economics—especially its macroeconomics—is ill-suited for analysis of institutional reforms. Neoclassical economics neglects the incentive effects of differences between countries in legal and cultural (formal and informal) institutions.[14] Thus, the neoclassical way of thinking has moved the carriers of institutional restructuring *away* from the search for formal institutions and the optimal rate of their development, which, in association with the prevailing informal rules, would create confidence in the rule of law, make private-property rights credible, provide incentives to innovate, and reduce the transaction costs of exchange. Instead, the neoclassical way of thinking has moved the carriers of change *toward* the evaluation of the results of reforms in terms of quantitative benchmarks such as economic growth, productivity of resources, inflation, employment, unemployment, and income per capita, which provide little information about the sustainability of those results under different institutional arrangements.

For example, the Czech Republic and Hungary are clearly ahead of Belarus and Russia in the transformation from socialism to capitalism. Yet in 2002 economic growth rates in the Czech Republic, Hungary, Belarus, and Russia were 2 percent, 3.3 percent, 4.1 percent, and 5 percent, respectively. Also, we observe good quantitative indices across a range of institutional arrangements. The centrally planned economy of the USSR, the labor-managed economy of former Yugoslavia, and the social-market economy of Germany had high growth rates in the 1950s, 1960s, and 1970s, respectively. However, those growth rates proved to be unsustainable. In contrast, the U.S. economy, which has done a better job of maintaining credible private-property rights and relatively low transaction costs (thanks to more transparent markets), has sustained, with many ups and downs, a reasonable rate of economic growth for two centuries.

Failure to Decommunize

While failing to appreciate the importance of the incentive effects of different institutional arrangements on the transaction costs of carrying out reforms, the carriers of institutional restructuring also failed to appreciate the importance of both the decommunization of C&EE and the assignment of the value of state-owned assets to their rightful owners.

The transition from socialism to capitalism depends on substantive changes in formal institutions and their interactions with the prevailing informal rules. Institutional restructuring, then, is a legal and cultural problem rather than merely a techni-

14. Andrew Schotter writes: "The only institutions existing in [the neoclassical model] are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have . . . none of the many social institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices" (1983, 675).

cal one (Colombatto 2001, 285). Therefore, institutional changes require changes in human habits, customs, and informal norms of behavior. People who have lived for decades under arbitrary Communist leadership need time to adjust to the differences between the incentive effects of the institutions of socialism and capitalism, which are substantial.

In socialism, the political-scientific elite determines the desired economic outcome. In a free-market, private-property economy, individuals are the only judges of their own ends. The rules of the game in socialism seek to coerce individuals to pursue the desired outcome. The rules of the game in capitalism seek to create an institutional environment conducive to individuals' pursuit of their own ends, whose ultimate upshot is unknown. Capitalism rewards performance, cultivates risk taking, promotes individual rights, and supports behavior based on self-interest, self-responsibility, and self-determination. Socialism supports income redistribution, social insurance coverage, mandated educational choices, and the regulation of markets.

The *carriers of change,* then, must smooth the path of institutional restructuring in C&EE (or anywhere else). The real carriers of change are individuals because governments, think tanks, universities, and other organizations as such do not make decisions; only individuals can do so (Alchian and Allen 1964, 12). Individuals conceive reforms and persuade others to enact them into laws and regulations. We can distinguish two groups of institutional reformers in C&EE: those who enact institutional reforms and those who implement them. Given the lack of transparency in public life as well as the built-in disrespect for laws, both of which are predictable consequences of the decades of socialist rule, those who enact new formal rules face high transaction costs in monitoring those who implement them.

The path of transition in C&EE has depended as much on those in charge of implementing institutional reforms as it has on those who formulated them. In a world of bounded rationality, individuals belonging to these two groups are likely to have different perceptions of reality and, consequently, different incentives. Thus, institutional restructuring has produced different results in C&EE countries, even in culturally similar countries, such as the Czech Republic and Slovakia (Pejovich 2003). It is therefore important to ask who the carriers of change are, what their preferences and incentives are, and whether those incentives have affected the results of the privatization of state-owned firms.

The carriers of change in C&EE are primarily decision makers in government, bureaucrats, managers of business firms, labor union leaders, and other social engineers. The point of great importance is that a significant number of those people are holdovers from socialist regimes. Why is this the case, and what are the implications?

After 1989, Communist parties in C&EE were not outlawed. Attempts to exclude former top leaders and security officers from important government jobs were made in some countries (for example, the Czech Republic). However, those attempts eventually petered out to such an extent that even the establishment of the museum of communist crimes in Budapest encountered serious opposition from politicians and bureaucrats. Most important, the Communist parties were not declared to have been criminal organizations.

The absence of decommunization in C&EE contrasts with the de-Nazification in Germany at the end of the World War II. The National Socialist Party was outlawed, its top leaders were sent to the gallows or prisons, and lesser functionaries (especially members of the SS) were barred from holding important positions in public life. Then the Cold War created a strong demand for German scientists, intelligence officers, and business leaders. Instead of continuing to send war criminals to prisons, the West and the East began to compete for their skills. The process of de-Nazification eventually petered out. However, even the partial de-Nazification eliminated a large group of well-positioned people from the transition process in postwar Germany. This group's comparative advantage, like that of Communists, lay in the operation of an arbitrary state.

In contrast, Communist Party leaders in C&EE were not brought to justice. Former nomenclaturists were not excluded from public-policy making. The bureaucracy of C&EE has hardly changed since the end of socialism. Scholars who belonged to the Communist parties did an about-face, affiliating themselves with Western universities, the United Nations, the European Union, the World Bank, and other Western organizations, and they were quickly acclaimed as internationally recognized transition experts. Thus, the carriers of change in C&EE since the outset of economic reforms in the early 1990s—not exclusively but to a significant extent—have been individuals who used to be members of the Communist parties before the end of socialist rule in the late 1980s (hereafter, I refer to them as "former Communists").[15] Whatever the facade of words behind which they hide, these people have a comparative advantage in making and implementing policies that favor collectivism and dirigisme. In this regard, two points merit consideration.

First, although many former Communists are sincere in their about-face, others are merely paying lip service to a free-market, private-property economy. For example, a political philosopher from Serbia told me that when the Democratic Party of Serbia was formed (toward the end of 1980s), the late Zoran Djindjich, one of its founders, had to be persuaded that private-property rights should be an important part of the party's program. That same Djindjich was later, as prime minister of Serbia, marketed all over Europe as a free-market reformer. Few people paid attention to the fact that he had also applied for his party's admission to the socialist international. Moreover, even the former Communists turned sincere free-market supporters remain subject to the habits and customs they acquired during socialist rule; hence, when faced with a problem, they go to the state. For example, post-Milosevich leaders in Serbia claim to be carrying out serious free-market reforms. Perhaps they believe what they are saying. Yet *Ekonomist Magazine,* a respected weekly journal in Belgrade, notes (August 16, 2002, p. 7) that not much has changed since the supposed end of socialism. The

15. Socialism ended in 1989 or soon afterward. Most members of the Communist parties in C&EE joined other political groups. Some are still Communists.

Serbian government runs the economy, Serbian ministers run business firms, and the governor of the Serbian National Bank runs commercial banks.

Second, it is wrong to separate former Communists, as many people in the West have been doing, into those who joined the party for ideological reasons and those who did so seeking promotions and privileges. The first group imposed the oppressive dictatorship, and the second group reduced the costs of maintaining it. Given their comparative advantage in dirigisme, former Communists prefer discretionary policies to the rule of law. They see the state not as a necessary predator, which the rule of law must tame, but as a leading force in the organization of economic activity. Statements about the role of the state in the economy by two scholars—the first a leading figure of the Chicago school (and a Nobel laureate), the second a former Communist—illustrate this point. George Stigler wrote: "The state is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries" (1971, 3). While paying lip service to market reforms—typical behavior of most illiberal economists who are trying to balance their preference for dirigisme with the inescapable evidence that markets work—a former member of the Communist Party of Poland, Grzegorz Kolodko, remarks: "If there is a choice between developing these [free-market] institutional arrangements spontaneously *(by chance)* or in a way directed by the government *(by design)*, then the latter option is more suitable in the case of postsocialist countries. . . . Even if a small government is sometimes better than a larger one, often government cannot be downsized without causing economic contraction and deterioration in the standard of living" (2002, 76, emphasis added).

Table 1 supports the argument that the failure of decommunization in C&EE has played a role in slowing down—and in some countries (e.g., Russia) reversing—the transition to greater economic freedoms and more efficient privatization. In contrast, the Baltic states have the best scores in the region. In the 2005 Index of Economic Freedom, scores for Estonia and the United States are 1.7 and 1.9, respectively. One reason for those high scores is that Russians held most decision-making positions in the Baltic states. In the early 1990s, most of these Russians fled to Russia. In that way, the carriers of change in the Baltic states were, at least in part, decommunized.

This is not to say that the carriers of change have been openly sabotaging the process of transition. As table 1 shows, the average scores of C&EE countries improved significantly between 1996 and 2005. However, the carriers of change in C&EE, given their preferences and habits acquired during socialist rule, are likely to have little appreciation for the incentive effects of private-property rights and a strong bias in favor of government regulation. A reasonable expectation, then, is that whatever the overall scores are, the scores for private-property rights and government regulation in C&EE countries will be lower. If so, what are the implications of their dampening effects on the overall scores of C&EE countries?

Table 1
Economic-Freedom Scores in Central and Eastern Europe

COUNTRY	Scores in 2005			Scores in 1996		
	Total	PR	REG	Total	PR	REG
Estonia	1.7	2.0	2.0	2.4	2.0	2.0
Lithuania	2.2	3.0	3.0	3.5	3.0	3.0
Latvia	2.3	3.0	3.0	3.2	3.0	3.0
Czech Republic	2.4	2.0	3.0	2.3	2.0	1.0
Slovakia	2.4	3.0	3.0	3.2	3.0	3.0
Hungary	2.4	2.0	3.0	3.0	2.0	3.0
Poland	2.5	3.0	3.0	3.2	2.0	3.0
Slovenia	2.5	3.0	2.0	3.7	4.0	3.0
Bulgaria	2.7	4.0	4.0	3.5	3.0	4.0
Albania	2.9	4.0	4.0	3.6	3.0	3.0
Croatia	3.0	4.0	4.0	3.5	3.0	4.0
Moldova	3.1	3.0	4.0	3.5	3.0	3.0
Ukraine	3.5	4.0	4.0	3.7	4.0	4.0
Russia	3.6	4.0	4.0	3.6	3.0	3.0
Romania	3.6	4.0	4.0	3.4	4.0	4.0
Belarus	4.0	4.0	5.0	3.4	3.0	3.0
AVERAGES	2.8 (2.1)	3.3 (1.5)	3.4 (2.7)	3.3 (2.3)	2.9 (1.5)	3.1 (2.5)

Source: Miles, Feulner, and O'Grady 2004, 2005.

Note: Scale is 1 to 5, with 1 representing the greatest economic freedom. *Total*, *PR*, and *REG* denote the scores for the total, property rights, and government regulation categories, respectively. The index has nine categories, including *PR* and *REG*. Macedonia, Bosnia and Herzegovina, and Serbia and Montenegro were not ranked in 1996. Serbia and Montenegro was not ranked in 2004. The first index was published in 1995. The figures in parentheses are averages for six Western countries: France, Germany, Italy, Spain, the United Kingdom, and the United States.

Table 1 lists C&EE countries in order of their overall economic freedom scores (first column) as reported in the 2005 Index of Economic Freedom. Between 1996 and 2005, the average scores for sixteen countries improved from 3.3 to 2.8.[16] During the same period, the mean scores for private-property rights (PR) worsened from 2.9 in 1996 to 3.3 in 2005, and the average scores for government regulations (REG) deteriorated from 3.1 in 1996 to 3.4 in 2005. For comparison, during the same period, the total average score for six major Western countries (the United States, the United Kingdom, Spain, France, Germany, and Italy) improved from 2.3 in 1996 to 2.1, the credibility of private-property rights remained the same, and the average score for government regulation worsened from 2.5 to 2.7. In 2005, the United States fell, for the first time since 1995, below the top ten economically freest countries.

Table 1 provides additional evidence that the failure to decommunize C&EE has created incentives for the carriers of change to keep the scores for property rights and government regulation below those of other categories considered in the Index of Economic Freedom. The top eight countries in table 1 are C&EE countries, and the remaining eight are in the Balkans and the former USSR. The overall mean score of the top eight countries, which had been open to the West before the imposition of socialism, improved from 3.1 to 2.3 between 1996 and 2005. Yet their average scores for property rights remained the same (2.6), and the average score for government regulation worsened somewhat, from 2.6 to 2.8.

The lower eight countries, which had experienced less influence from the West (with one exception, Croatia), show a greater divergence between the overall score, on the one hand, and the average scores for private-property rights and government regulations, on the other. Although their overall scores remained roughly the same (3.5 in 1996 and 3.3 in 2005), the average score for private-property rights worsened from 3.3 to 3.9, and the average score for government regulation changed from 3.5 to 4.1.[17] Interestingly, the credibility of private-property rights and government regulation in Albania and Bulgaria, the two countries that the index moved in 2005 from a *mostly unfree* to a *mostly free* ranking, have failed to keep pace with the improvement in their overall scores.

The failure to decommunize C&EE explains why former Communists are among the carriers of institutional restructuring in these countries. This fact is common knowledge in C&EE, as is the fact that former Communists' strength grows the farther east and southeast we travel. Given their habits and customs of the past, former Communists, although not always intentionally, are favoring policies that attenuate private-property rights and increase regulations. Indeed, the evidence in the *Index of*

16. As indicated in table 1, Serbia and Montenegro was not ranked in either 1996 or 2005. In 2005, Bosnia and Herzegovina and Macedonia (also not listed in table 1) received overall scores of 3.2 and 3.0, respectively, but their scores for property rights and government regulation were 5.0 and 4.0, respectively—significantly worse than their overall scores.

17. For analysis relating differences in cultural tradition among C&EE countries to their attainment of economic freedoms, see Pejovich forthcoming.

Economic Freedom is that the scores for private-property rights and government regulation have been worse than the overall scores in C&EE. The consequences of the failure to decommunize on the credibility of private-property rights and the extent of regulations become even more obvious when we separate C&EE countries from the Balkans and the former USSR.

This bias against private-property rights and in favor of government regulation affects the results of the privatization of state-owned firms. Credible private-property rights are the basic prerequisite for successful privatization. Government regulations distort the terms of exchange that individuals prefer. Hence, the incentive effects of the attenuation of private-property rights and of growing government regulation raise the transaction costs of moving privatized assets to their most valuable uses. In this sense, the privatization of state-owned assets has failed to contribute to the objective of institutional restructuring in C&EE.

The Convergence of Economic Efficiency and Morality: Who Owns Privatized Firms?

State-owned assets differ in the West and C&EE. In the West, public leaders acquire state-owned assets within the constraints of their constitutions. Given those constraints, the presumption is that public leaders have the citizens' consent to sell state-owned assets and to allocate the proceeds. Moreover, the transfer of state-owned assets occurs in a market-friendly and well-established institutional environment in which the transaction costs of moving privatized assets to higher-valued uses are low. Thus, if privatized assets were not sold initially to the users who can put them to their most valuable uses, the prevailing incentives would move those assets subsequently into the hands of more productive owners.

In the former socialist states, state-owned assets either had been stolen from their legitimate owners (via nationalization, expropriation, and confiscation) or had been produced by socialist planners at the request of Communist leaders. The presumption is that Communist leaders had only the consent of party members to acquire, produce, and use productive assets.[18] All other citizens were compelled to bear the costs of submitting to their rulers' preferences. The true owners of state-owned assets are all the individuals who were forced to bear the costs of producing state-owned assets. That group of individuals includes all citizens except those who joined the Communist Party before the end of socialist rule in 1989.

By implication, acting as an intermediary for the true owners of state-owned assets, the state might sell those assets, but it has no right, as in Western countries, to keep the proceeds or even to choose how to allocate them. The state's moral obliga-

18. It is likely that many Communists did not agree with decisions that leaders made. Nevertheless, they implicitly accepted their leaders' policies. Membership in the party in the former USSR was voluntary, and people joined it because of their belief in its ideals or in search of a better life.

tion clearly is to return the value of state-owned assets to all citizens.[19] Moreover, I maintain that economic efficiency also calls for the return of state-owned assets to all citizens. (The term *all citizens* recognizes that decommunization did not happen in C&EE. Thus, former Communists have to be considered, along with other citizens, as true owners of state-owned assets. This adjustment has both current and future costs. As we have seen, by remaining in public life, former Communists have contributed to the costs of transition to free-market, private-property economies. As for the future, the failure to exclude Communists from public life encourages careerists and opportunists to join oppressive regimes.)

The privatization of business firms in C&EE differs both economically and morally from the privatization of state-owned firms in the West. First, state-owned assets in C&EE were not produced with citizens' consent. Hence, no presumption exists, as it does in the West, that new leaders in C&EE have the right to choose how to use those assets. Second, the institutional environment in C&EE is not yet market-friendly. Thus, if the first sale of state-owned assets failed to put them into the hands of the best user, there is no compelling reason to believe that accurate pricing will quickly remedy the situation. To convince citizens of the desirability of the rule of law, constitutional democracy, and competitive markets will require time, a great deal of resources, and supportive governments. Development of a free market for institutions should have paved the way for privatization (Pejovich 1994).

If the right of ownership in state-owned assets extends to all citizens, C&EE governments have an obligation to seek the lowest-cost method of privatizing state-owned firms and transferring the proceeds to all citizens (hereafter *the owners*). Unlike their counterparts in the West, who can choose how to use the proceeds from privatization, C&EE governments should be no more than intermediaries in the process of privatizing state-owned firms. Among the major methods of privatization in C&EE have been voucher privatization, direct sales, equity offerings, contracts with strategic (foreign) partners, and internal buyouts by managers or employees. Leaving voucher privatization for later discussion, we may note that all other privatization methods differ in their expected economic efficiencies, but none of them has satisfied the requirement of returning the value of privatized assets to the owners.

The initial objective of direct sales was to sell state-owned assets to foreign or domestic buyers. In addition to importing new funds, selling assets to foreign partners and direct buyers from abroad also brings in technical and managerial skills that are in the short supply in C&EE. However, in some C&EE countries, powerful local interests, managers of business firms, and employees' associations have opposed or slowed down, for self-serving reasons, the direct sale of state-owned assets to foreign buyers. And successful domestic buyers who show too much independence from politicians

19. Losses suffered by non-Communists during socialist rule were not identical. However, it is likely that the marginal costs of calculating individual losses would exceed the benefits long before all citizens could be compensated for their individual pain and suffering during the socialist years. For present purposes, the important point is that the value of privatized assets should be transferred to citizens.

and bureaucrats are often suppressed, sometimes jailed (as in Russia), and almost always overregulated and overtaxed. Thus, cultural and legal constraints have reduced the efficiency of direct sales privatization in C&EE.

Three factors constrain the transition to capitalism through equity offerings: the lack of institutional developments to make financial markets more transparent; legal changes that favor the protection of creditors at the expense of shareholders; and decision makers' failure to recognize that protection for the individual shareholder depends on cheap "exit" rather than on "voice."[20] Protection of creditors at the expense of shareholders discourages the dispersion of shareholding and thus promotes concentrated ownership. Privatization through equity offerings then loses the benefits of dispersed shareholding, such as the creation of funds for economic growth without a concentration of economic power, the development of a middle class with a diversifiable stake in the economy, and individuals' ability to reduce the risk of innovation through diversification of their portfolios.

The tendency in most C&EE countries is to give managers and employees a large number of shares (free or heavily discounted) in their respective enterprises. According to a World Bank study (Mitra et al. 2000, 75), nine out of eighteen C&EE countries have used internal buyouts as their primary or secondary method of privatization. This method of privatization is both morally wrong and economically inefficient. It is morally wrong because there is no compelling evidence that employees of socialist firms were paid less than their opportunity costs. Moreover, state-owned firms in the socialist years were known for shirking employees, inefficient managers, and the poor quality of output. Thus, society has no reason to compensate these people. Arguably, the employees and managers of state-owned firms should compensate the rest of society.

Management-employee buyouts also entail serious economic inefficiencies. Labor-managed firms employ excess workers, make inefficient investment decisions, and lack the skills required to survive in a market-friendly institutional environment. Most labor-managed firms require subsidies to survive. Managers and employees of those firms therefore have an incentive to make deals with politicians and bureaucrats who, in turn, have an incentive to offer subsidies (paid by others) to managers and employees in exchange for pecuniary and nonpecuniary benefits. Predictably, the arrangements between managers and employees, on the one hand, and politicians and bureaucrats, on the other, have been a major source of corruption in C&EE and have been characterized as "institutionalized stealing" (Milovanovich n.d.). It is not surprising, then, that politicians and bureaucrats prefer internal buyouts to other methods of privatization.

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20. In a very interesting and well-documented paper, Katharina Pistor (2000) argues that the emphasis on the protection of creditors is stronger in C&EE countries that have been influenced by the German and French legal systems.

All these and similar methods of privatization have one common characteristic: C&EE governments have not transferred the proceeds from the sale of state-owned assets to the owners. Some governments have spent those proceeds to beef up pension funds. Others use them to subsidize bankrupt companies. Some governments deposit the proceeds in various state-controlled development funds. Some even use the proceeds to balance their budgets. A comprehensive study on institutional restructuring in Serbia concludes: "Privatization has been reduced to the selling of state owned property for the sake of ensuring the liquidity of the budget. This is wrong because privatization proceeds should not end up in current spending.... Moreover, there are no precise records on how these resources are spent, which compromises both the transparency and efficiency of the entire process" (Jovanovich and Vukotich 2004, 137).

An important common trait of all these methods of privatization is that C&EE governments have assumed the right to allocate the proceeds from the sale of state-owned firms to benefit specific groups. Government leaders derive their power and influence from the size of their budgets. Thus, one does not have to be a public-choice scholar to understand why C&EE governments find it in their self-interest to behave as if the state indeed were the true owner of the now-privatized assets and to keep the proceeds derived from selling them.

The excuses offered for keeping the proceeds are usually very flimsy. At a conference in Budapest in the early 1990s, the then Hungarian minister for privatization said that the state was not in the business of giving away the national wealth. Clearly, the minister chose to ignore the fact that privatizing state-owned assets and giving the proceeds to all citizens does not change the stock of productive assets, but only their legal owners. The morality of transferring the proceeds from the sale of state-owned assets to the owners is clear. The issue is whether the transfer of the proceeds from sale of state-owned firms to all citizens can also be justified on grounds of economic efficiency.

Suppose that an asset X is to be privatized. In the absence of competitive markets, we do not know its market value. To simplify our analysis, let us assume that the present value of X is $1,000 and that the government somehow obtains the right price for it. Using different numbers for the value of X and the price obtained by the government would not affect the results of the analysis (except for some redistributional effects). Let us also assume the best possible method of privatizing X: it is sold to a foreign buyer.

If the state kept the proceeds from selling state-owned assets, the private sector would receive $1,000 worth of resources (X) and would transfer $1,000 (presumably in cash) to the government. The government still ends up controlling $1,000 worth of resources. The allocation of the control over resources between the private and the public sector is the same as before the privatization, except that the government has changed the portfolio in which it holds its wealth. Instead of $1,000 worth of X, the state holds $1,000 in cash.

As noted earlier, there are compelling analytical reasons, supported by empirical evidence, to say that $1 worth of resources in the private sector will be used more efficiently than $1 worth of resources in the public sector.[21] By implication, the use of $1,000 received by the state will be less efficient than if those funds had remained in the private sector. We can say, then, that the privatization of X in this case, even though it went to the presumably most efficient purchaser, has not improved the overall economic efficiency of the use of resources. Moreover, by keeping the proceeds from sale of X, whatever the noble purpose those proceeds might be said to serve, the state has also stolen property from its rightful owners.

Assume now that C&EE governments assign the right of ownership in state-owned assets to all citizens. In our case, the state would have to return to the owners $1,000 received from selling X. The return of $1,000 to the owners (via tax refunds or any other means that is not expensive and that reaches all owners, minus administrative expenses) changes the allocation of resources between the public and private sectors. The private sector now controls an *additional* $1,000 worth of resources, and the state has lost control over $1,000 worth of resources (that is, the proceeds from sale of X). In this case, the privatization of X will tend to improve the overall economic efficiency of the use of resources. Moreover, the transfer to the owners of the proceeds from the sale of X will provide compensation for past wrongs.

Of all the different methods of privatization that have been tried in C&EE since the early 1990s, only voucher privatization, pioneered by Vaclav Klaus, comes close to having all citizens receive the value of state-owned assets. In this method, the government gives away vouchers or sells them for a nominal fee to all citizens, who can then sell them in the market or use them to purchase shares in business enterprises. However, voucher privatization created wide dispersion of shareholding. In countries with transparent financial markets and strong protection of minority shareholders, the dispersion of shareholding is welcome news. However, wide dispersion of shareholding in a region with rudimentary financial markets and non-credible property rights produced considerable agency costs, created opportunities for "tunneling" (Johnson et al. 2000), and increased the transaction costs of controlling the behavior of managers. Predictably, the managers, controlling shareholders (including investment funds), employees, and other rent seekers have been able to make profitable "arrangements" with politicians, bureaucrats, and financial institutions. Hence, voucher privatization, an excellent idea in principle, created neither respect for private-property rights nor incentives for the owners to seek the best uses for their assets. Using the state as an agent to sell state-owned firms and return the proceeds to the owners is a better solution.

21. Although exceptions to this rule may be found, they do not invalidate the rule as a statement of generally prevailing conditions.

Conclusions

Because private firms outperform state-owned firms, the privatization of state-owned firms in C&EE has improved the efficiency of the privatized resources. However, improvements in the efficiency of privatized assets should not be confused with the success of privatization in helping C&EE countries to pursue the objective of transition from socialism to capitalism.

Privatization of state-owned assets has failed to contribute to the transformation of C&EE countries into free-market, private-property economies. As indicated in the present analysis, three critical factors are responsible for the failure of privatization to make a real contribution to institutional restructuring in C&EE: the reliance on neoclassical economics, the absence of decommunization in C&EE, and the unwillingness of the new elite in the region to assign the right of ownership in state-owned assets to the true owners.

With only a few exceptions, such as Klaus and Laar, most new leaders in C&EE have been using the rule of law, constitutional democracy, and competitive markets as a verbal facade that conceals their preference for dirigisme. The neoclassical economics way of thinking released them from having to explain their preference for policies promising desired results rather than the development of institutions that allow individuals to follow their own chosen paths, which would give rise to the creation of unknown social outcomes. In short, the rule of law, credible private-property rights, and free exchange create the foundation for a process that encourages individuals to identify, test, and select, via voluntary interactions with other individuals, the rules of the game for their community.

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