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A POST KEYNESIAN CRITIQUE OF PRIVATIZATION POLICIES IN TRANSITION ECONOMIES

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Abstract: The privatization policies implemented in transition economies were based on the neoclassical principles of economic thought. The neoclassical privatization policies contributed to the well-known results of a large reduction in output, high unemployment and inflation and a breakdown of institutional norms resulting in corruption and illegal activities. For the post Keynesians, there could have been a transition to a market economy without a substantial change in property ownership. This was because ownership, as such, was less important than competition, the incentive structure and the nature of regulatory policies. Consequently, post Keynesian policies of privatization would had resulted in a substantially smaller social cost of transition. Copyright © 2002 John Wiley & Sons, Ltd.

1 INTRODUCTION

The implementation of the neoclassical policies in the Commonwealth of Independent States (CIS), Central and Eastern Europe, either in the form of shock therapy or gradualism, highlighted the urgent need of privatization of state enterprises. However, both transition processes, either shock therapy or gradualism, resulted in a substantial social cost: a large reduction in output, high unemployment and inflation and a breakdown of institutional norms resulting in corruption and illegal activities. This paper is a critique to the neoclassical privatization policies based on post Keynesians propositions and attempts to offer an alternative set of privatization policies. Privatization was singled-out by all schools of economic thought as the most important transition policy, due to the direct link with output, employment and inflation. Effective privatization policies would have substantially reduced the social cost of transition.

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2 THE APPLICABILITY OF POST KEYNESIANISM FOR TRANSITION ECONOMIES

Post Keynesiansism is based on the writings of John Mayard Keynes, particularly *The General Theory of Employment, Interest and Money* which has imperishable relevance to current economic and social problems (Shackle, 1973, p. 516). Keynes 'hated unemployment because it was stupid and poverty because it was ugly' (Robinson, 1974, p. 10). The differences between methods of analysis are not based on varying subject matter, but rather on different views of economic life and activity (Shapiro, 1977, p. 552). In the case of the post Keynesians, they offer a different vision of what is a good society, which requires an alternative economic theory (Arestis *et al.*, 1999, p. 531).

Post Keynesians reject the three assumptions of orthodox economic theory: that the economic environment is ergodic (that the future can be estimated from past statistical information), the neutrality of money (changes in money cannot influence real economic variables) and gross substitution (everything is substitutable for everything else). Post Keynesianism is a more general theory because it is based on fewer assumptions, due to 'fewer intellectual blinders, while still providing a workable model to explain the system's laws of motion' (Eichner, 1979a, p. 16). The transition process was a non-ergodic process because neither the result nor the probability distributions could be deduced from the past. The transition was an unfamiliar idiosyncratic process. Keynes (1936) declared that 'we simply do not know', which clearly was relevant for transition economies.

Post Keynesians are concerned with history, uncertainty, distributional issues and political and economic institutions, all of which influence the determination of output and employment (Arestis *et al.*, 1999, p. 528). The economic system is defined as an amalgamation of social institutions responsible for satisfying the material needs of the members of the society by producing and distributing the social surplus (Eichner, 1979b, p. 171). The concept that the economy moves to a unique and exogenously established equilibrium has no relevance for the real world (Davidson, 1994, p. 17; Cornwall and Cornwall, 1997, p. 538). The capitalist economic system lacks any internal self-correcting mechanism for maintaining appropriate levels of aggregate demand, low levels of unemployment and stable prices. Thus, government economic policy was essential in avoiding such market failures (Cornwall, 1979, p. 26; Cornwall and Cornwall, 1997, pp. 525 and 538). Post Keynesians elevate the role of effective demand in a monetary economy as the engine of economic growth, and this distinguishes post Keynesianism from other schools of economic thought.

The basis of post Keynesian economics is the uncertainty of the future. The economy operates in historical time, which implies that its past is unchanged and that the future is uncertain. Economic actors make decisions with partial ignorance due to the fact that information does not exist and cannot be inferred from any existing data (Moore, 1979, p. 121; Setterfield, 1998, p. 168; Dequech, 1999, p. 415). Thus, 'history matters and agents are uncertain' (Dunn, 2000, p. 4). Once uncertainty is recognized as a deep attribute of real-world economies, the traditional concept of equilibrium is undermined and the simplistic propositions of laissez-faire are no longer relevant (Robinson, 1979, p. xi; Minsky, 1996, p. 367). This is because uncertainty about the future results in economic crisis and instability (O'Hara, 2000, p. 129). The uncertain future involves creative economic activity, in that individuals firms or governments can permanently change the future in a way not envisaged by the creators of change (Davidson and Davidson, 1996, p. 482). In a world of rational expectations, the future is a statistical image of the past,

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while in a world of uncertainty, the current outcome cannot provide information about the future accurately; thus free markets are not necessary efficient (Davidson, 1994, p. 72).

The post Keynesian model incorporates oligopolistic mark-up pricing, investment behaviour integrated with pricing, and money wage determination based on conflict (Norman, 1996, p. 518). It is investment, not relative prices, which is the central point in an economy. Investment is dynamic, constantly in motion, and never resting in an 'equilibrium' position. Money and monetary institutions are extremely important in influencing economic activity and are thus not 'neutral' (Keynes, 1936). In contrast to the neoclassical view, money can influence real and nominal economic variables in the short and long run (Davidson, 1994, p. 17). In a monetary economy output is determined by effective demand and there is no reason why effective demand should be at the level of full employment. The institutional framework of the economy is incorporated in the analysis, influencing the cyclical processes and the growth of the economy.

Post Keynesian policy recommendations would have been applicable to the transition economies where uncertainty was such a characteristic of the process. In addition to the uncertainty associated with the normal functioning of the market, the transition process gave rise to 'transition uncertainty'. The transition uncertainty was due to institutional and systematic transformation, behavioural inheritance of the past and political and social changes (Lah and Susjan, 1999, p. 591). The traditional notion of rationality (optimal positions are always calculable) of the neoclassical model was irrelevant. Procedural notion of rationality (the limited ability to process information) of the post Keynesian model was applicable for transition economies, due to the inability of the individuals to process information under transition uncertainty.

3 WAS PRIVATIZATION NECESSARY?

In the CIS, Central and Eastern Europe, the reform governments believed that there would only be a small 'window of opportunity' to implement necessary changes. Consequently, the reformers aimed to rapidly implement the changes, in particular privatization (Friebel, 2000, p. 38). However, expected privatization was a disincentive to managers because it did not stimulate improvements in production. The managers were more likely to speculate by hoarding resources and hiding information, as in the past, reducing the value of the enterprise and making it less attractive to outside buyers. This facilitated 'spontaneous privatization'—the transformation of state enterprises into joint-stock companies—whereby the managers became the new owners. Managers were able to use their discretionary power in a distorted market for their own gain, free of any institutional controls. Examples included: bankrupting enterprises so they could be bought cheaply, creating paper firms owned by the manager trading with the state firm and accepting or rejecting joint ventures or take-over offers on the basis of personal enrichment and/or security of position. Meanwhile, the owners of newly privatized firms, usually the former managers, engaged in asset stripping. In addition to finished goods, the new owners sold raw materials, intermediate goods and plant and equipment and deposited the revenue in their foreign bank accounts.

According to the neoclassical transition model, the transfer of state property to the private sector would have improved efficiency because of the profit motive. This presupposed effective competition, and also assumed that profitability was the appropriate measure of efficiency. Meanwhile, firms found it necessary to enter into some loss-making

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activities so they could retain a good reputation even amid fierce competition. In addition, the post Keynesians argued that privatization should not be used as a means of financing budget deficits. Empirical investigations confirmed that privatization policies, not only in transition economies but also in mature market economies, were motivated by an attempt to improve the budget (Bortolotti *et al.*, 2001, p. 128). Such a practice was myopic because it failed to consider the loss of future revenue streams. Profits of state enterprises were part of the government revenue, a company tax could not be considered a perfect substitute; thus privatization resulted in a substantial loss of government revenue. Additionally, the privatization of state enterprises would also lead to a reduction in spending for social services, as the state enterprise also played the role of a provider of social welfare (Kapstein and Milanovic, 2000, p. 16; Djankov and Murrell, 2000, p. 8). Consequently, 'privatization in itself is neither necessary nor sufficient for allocative efficiency' (Horne, 1995, p. 385). Poland, which implemented shock therapy, implemented a slow privatization process with little asset stripping and retained significant taxation, and thus protected its fiscal base to pay pensioners relatively well (Kapstein and Milanovic, 2000, p. 1).

The superiority of private property assumed that the enterprise owners were preoccupied with the management of the enterprise, or that they were able to put pressure on management to follow their decisions. The post Keynesians claimed, however, it was very difficult for owners to be able to exert any pressure on the management. Even in mature market economies, with a shareholding culture and well-informed shareholders, shareholders could only put moderate pressure on management. In the former centrally administered economies, where there was a lack of ownership skills, inappropriate information and the legacy of gigantic enterprises, management effectively had total control of the decision-making process. In mature market economies as enterprises grow, the more ownership is separated from management and the more likely management is to pursue independent goals. Thus 'the link between ownership, effort and reward in manufacturing is indirect and fuzzy' (Bunknall, 1997, p. 12).

The neoclassical transition model's assumption that private property results in efficiency could only be true if ownership and managerial skills appropriate to the 'free' market process were inherent and not learned. In contrast, if ownership and managerial skills were taught and time-consuming to acquire, the result would be a different combination of skills and hence ownership and co-ordination structures different from those defended by neoclassical supporters. The achievement of a civilized society, which is the goal of post Keynesians (Davidson and Davidson, 1996; Marangos, 2000–1), would ensure that management would be representative of society and motivated by civic values, giving rise to civilized leadership interested in more than optimizing resource allocation.

The superiority of private property over state property, as a number of economists argued, should not be interpreted as implying that state property did not have a role. There was a role for state property in areas where private property did not function efficiently, that is, whenever there was market failure. The contentious issue is whether state property should be instituted beyond the areas of market failure. Post Keynesians would argue that there is a role for state property beyond market failure (Targetti, 1992, p. 6). In addition post Keynesians claimed that market failure was extensive, encompassing market power and information. Their main contention, however, was that the majority of property should still remain in private hands. For Mongolia, Anderson *et al.* (2000) found that state owned enterprises perform better than privatized firms. Interestingly, in the Czech Republic—which implemented shock therapy and is one of the transition economics most advance in

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private sector development—the state continues to play a major role. The state retains all of or a majority stake in the major utilities; majority stakes in 40 large firms and banks designed as 'strategic'; majority stakes in 30 non-strategic firms; minority stakes in about 300 other firms; and indirect ownership and control through the portfolios of banks and privatization investment funds many of whom are owned by state-dominated banks (Havrylyshyn and McGettigan, 1999, p. 5).

Vicker and Yarrow (1991, pp. 113–118) argued that empirical evidence demonstrated that private property had efficiency advantages in competitive conditions, but was not superior when there was market power. Meanwhile, when state-owned firms were subjected to competition similar to private firms, their performance was more efficient (Comiso, 1992, p. 228). It was not ownership that determined efficiency but environmental factors. Thus the development of competitive conditions and a regulatory framework should have been the goal, not ownership.

The case for privatization in the transition economies became even less clear when the underdeveloped markets for capital, corporate control and managerial labour were considered. The absence of a capital market in which take-over can be initiated, the lack of corporate control in the form of institutional norms and the substantial imperfections in the managerial labour market, could only promote managerial failure. Under these conditions, enterprise managers did not behave in an 'optimal' way as prescribed by the neoclassical model. This actually facilitated 'spontaneous privatization'—the transformation of state enterprises into joint-stock companies—whereby the managers became the new owners (Stark, 1990, p. 366; Eyal *et al.*, 1997, p. 88).

The post Keynesians concluded that no form of ownership was perfect. Private firms suffered market failures, a divergence between private and social benefits and costs. Public enterprises experienced government failures, a divergence between political and social benefits, and costs. Thus private ownership, while eliminating government failure, still gave rise to market failure. The most appropriate ownership structure depended on the magnitude of the imperfections. For this reason Stark (1996, p. 1023) argued that 'it is not in finding the right mix of public and private but in finding the right organization of diversity to yield both adaptability and accountability that postsocialist societies face their greatest challenge'. Consequently, there were no firm guidelines with respect to the appropriate ownership structure. The experience of mature market economies demonstrated the variety of ownership structures in market economies and the changing character of ownership structure over time. As such, the framework of political and social institutions, traditions and history and the state of economic growth of the particular country had to be included in the analysis of the development of property relations (Targetti, 1992, p. 6; Taylor, 1994, p. 80). A market economy requires not only liberal regulation and private ownership but also adequate institutions (Kolodko, 1999, p. 2). Empirical evidence reveals that the success of privatization in terms of revenues and stakes sold requires suitable legal institutions and developed capital markets (Bortolotti *et al.*, 2001, p. 109). Consequently, there was no single ideal strategy with respect to privatization. It had to be done on a by-case basis, depending on the type of the asset, the internal organizational structure, the level of technology and the need for capital. It appears that Poland's privatization strategy of slow and deliberate, even though Poland implemented shock therapy was more successful than Russia and Czech Republic's speedy privatization strategy (Havrylyshyn and McGettigan, 1999, p. 34).

Table 1 provides the methods of privatization in transition economies. Most transition countries, 20 in number out of 26 opted for direct sales-auctions. In 8 countries it was the

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Table 1. Methods of privatization of medium and large enterprises

Country	Direct sales	Vouchers	Management–Employee buyout
Central and Eastern Europe			
Albania	Not applicable	Secondary	Primary
Bosnia and Herzegovina	Secondary	Primary	Not applicable
Bulgaria	Primary	Secondary	Not applicable
Croatia	Not applicable	Secondary	Primary
Czech Republic	Secondary	Primary	Not applicable
Estonia	Primary	Secondary	Not applicable
FYROM	Secondary	Not applicable	Primary
Hungary	Primary	Not applicable	Secondary
Latvia	Primary	Secondary	Not applicable
Lithuania	Secondary	Primary	Not applicable
Poland	Primary	Not applicable	Secondary
Romania	Secondary	Not applicable	Primary
Slovak Republic	Primary	Secondary	Not applicable
Slovenia	Not applicable	Secondary	Primary
Commonwealth of Independent States CIS			
Armenia	Not applicable	Primary	Secondary
Azerbaijan	Secondary	Primary	Not applicable
Belarus	Not applicable	Secondary	Primary
Georgia	Secondary	Primary	Not applicable
Kazakhstan	Primary	Secondary	Not applicable
Kyrgyz	Not applicable	Primary	Secondary
Moldova	Secondary	Primary	Not applicable
Russia	Secondary	Primary	Not applicable
Tajikistan	Primary	Secondary	Not applicable
Turkmenistan	Secondary	Not applicable	Primary
Ukraine	Secondary	Not applicable	Primary
Uzbekistan	Secondary	Not applicable	Primary

Source: European Bank of Reconstruction and Development, 1999, p. 32.

primary method of privatization and in 12 the secondary. The voucher method was adopted in 19 countries; for 9 countries it was the primary method and for the remaining the secondary. Interestingly, the data for management–employee buyout, which was for 9 countries the primary method and for another 4 the secondary method of privatization, does not distinguish between managerial ownership and labour ownership. Enterprise insiders is a composite group, where workers and managers were not differentiated in empirical research (Djankov and Murrell, 2000, p. 32). The reason for this is provided by Frydman *et al.* (1999, p. 1170) was because enterprises owned by managers or employees 'are statistically impossible to differentiate from each other in terms of their post-privatization performance which makes it quite natural to look at them together'.

The neoclassical transition model highlighted the need for privatization of state enterprises, in the form of auctions (Kornai, 1990, p. 83; Kornai, 1992). However, according to the post Keynesians selling state enterprises to the highest bidder violated equity principles. The amount of savings available in the transition economies were not enough to finance a large privatization drive. The only people who could purchase firms were those who had benefited under the previous regime through the black-market and

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illegal activities. The typical answers from mainstream economists—'the firm is worth whatever someone is willing to pay for it' or 'let the market decide'—were problematic where there was not yet a market and where, in fact, the explicit motive for the sales was to create a market (Stark, 1990, p. 359). Among the transition countries, only Hungary and Estonia have managed to privatize a major share of their state enterprises through direct sales. At the end, Hungary sold heavily to foreign investors who had sufficient capital and were willing to incur the risks (Gray, 1996, p. 11). Poland and Romania pursued sales vigorously but with limited success.

There were political as well as equity reasons against auctioning firms, because there would be a lack of support from the majority of the people, the true owners of state assets. Meanwhile, contrary to the neoclassical transition model where culture did not matter, it appears that the privatization strategies pursed had a high degree of national path-dependence. This resulted in 'a complex mosaic of national and regional pathways' (Smith, 1996, p. 135). In addition, large-scale privatization was not essential to overcoming shortages as the neoclassical transition model stipulated. It appears that the soft budget constraint explained inflation rather than shortages (Ellman, 1994, p. 11). For these reasons the transition process called not for the dismissal of all state intervention and state property but for their streamlining and adjustment to the new conditions. Active state intervention was required using state property as a policy instrument since market outcomes are often the result of activities of various lobbies and informal organizations, including the organized crime (Kolodko, 1999, pp. 16, 17).

4 THE CONSEQUENCES OF IMPLEMENTING THE NEOCLASSICAL POLICIES OF PRIVATIZATION

Post Keynesians argued that the privatization process in the neoclassical model was formulated independently of any macroeconomic, political, bureaucratic and structural considerations. These elements of the transition process resulted in delaying privatization. The privatization process would be inhibited by economic uncertainty and by adjustment shocks inherited in the neoclassical transition model. Financing the purchase of enterprises with credit, in an unstable environment of sharp interest rate increases, could only deter privatization. Also, the recession created detrimental economic conditions for the new entrepreneurs (Rondinelli and Yurkiewitcz, 1996). The privatization schemes of the neoclassical model ultimately failed because the model did not provide any form of assistance to enterprises to overcome the difficulties associated with the introduction of market relations. 'In such circumstances, an absolute hardening of firms' budget constraints not only drives poorly performing firms into bankruptcy but also destroys enterprises that would otherwise be quite capable of making a high performance adjustment' (Stark, 1996, p. 1019).

The main objectives of privatization was to remove the state from ownership, the establishment of hard budget constraints, to avoid asset stripping and rent seeking and to eliminate the state from the decision making process within the enterprise (The World Bank, 2002, p.x; EBRD, 1999, p. 32). However, the removal of state property and directives made life very difficult for enterprises. Instead of a market network, there was a network of personal connections, based on 'whom you know' and what position the person held. It was a sad reminder of the past practices when supplies dried up, the managers depended on the '*tolkachi*' (= pushers) people with special connections who were able to

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cut through the bureaucracy and arrange supplies by any means, legal or not. Thus it was crucial to stimulate appropriate personnel changes in the managerial structure of enterprises to eliminate the principal–agent problem; however, the corporate network of mutual support maintained inefficient managers (Yavlinsky and Braguinsky, 1994, p. 91).

Thus, the implementation of the neoclassical model of privatization did not necessarily encourage restructuring rather resulted in a cruel deception, in which many individuals colluded, a few profited, and the public at large was the great loser (Oberschall, 1996, p. 1039). Privatization in an environment of hyperinflation and instability could only breed corruption. Instead of the development of an efficient private ownership structure, managers responded to the high level of uncertainty by breaking their firms along divisional, factory, departmental and workshop lines, into numerous joint stock and limited liability companies. A process of asset recombination of property was occurring, often behind the scenes, whether a recombination from state to private firms or from some private firms to other private firms (Gray, 1996, p. 11). This gave rise to a new form of ownership, which Stark (1996, p. 1014) named 'recombinant property'. 'Recombinant property is a particular kind of portfolio management. It is an attempt to have a resource that can be justified or assessed by more than one standard' (Stark 1996, p. 1014). In this way managers and banks controlled and reaped the benefits of the most profitable parts of the enterprise, while the unprofitable, loss-making and inefficient parts became the responsibility of the state.

Recombinant property did not increase efficiency because it did not reduce monopoly power since the same management effectively still controlled the numerous break-ups. In addition, there was a loss of economies of scale. Instead of genuine restructuring, there was a transfer of the responsibility to the state. The privatization programme in transition economies resulted in new forms of property in which the qualities of private and public ownership were dissolved, interwoven, and recombined. Property in East European capitalism is recombinant property, and its analysis suggests the emergence of a distinctively East European capitalism that will differ as much from West European, as do contemporary East Asian variants. Drawing on post Keynesians analysis, I would add however, that the scars of the neoclassical process could not be alleviated so easily; rather, their impact will be felt for a long time. The development of capitalism in the CIS, Central and Eastern Europe has taken place under the extreme and abnormal conditions of the shock therapy process, which the historical experience of civilized capitalism could not warrant.

Those who, due to their privileged position under the old regime, were able to exploit their status should not have been allowed to do so under the new economic conditions. The initial distribution of private property was paramount for the post Keynesians, since the initial distribution of property would determine those members of the society who could start from an advantageous position. It was anticipated that once the property rights were properly defined, the ownership of equity in privatized enterprises would be relocated to the most effective users. This conclusion was based on a simplifying assumption about the nature of capital markets in the transition economies and did not take into account the actual reality. In an environment in which market power was permanent, due to the nature of technology and industrialization, the 'free' market process would not be able to alleviate any of the inequalities arising; rather, these inequalities would increase in magnitude. This was in contrast to my interpretation of the shock therapy model, in which the initial distribution of property was irrelevant. For the shock therapy supporters, establishing a free-market environment would have ensured that only

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efficient owners would survive the market test. In a neoclassical transition economy, the only just distribution would be through a free market because it would not involve any form of coercion. However, given the high transaction costs and informational asymmetries of capital markets, the initial ownership structure has been sustained over time and, thus, the privatization methods used have govern the property ownership structure even after privatization (Pivovarsky, 2001, pp. 15–6, 21). Obviously, the distribution of property would influence inequality. Actually due to the privatization policies pursued in transition economies inequality has increased. Whereas the Russian Gini coefficient in income per capita terms was 24 between 1989–88, it doubled to 48 between 1993–95. The overall transition countries average increased from 24 to 33 during the same period. The United States had a Gini coefficient of approximately 43 (Kapstein and Milanovic, 2000, p. 9).

The free distribution of vouchers was widely used by transition economies, as revealed in Table 1, nine countries chose it as the primary method and another 10 as the secondary method of privatization. However, the myth behind the development of the widespread ownership of private property through the free distribution of vouchers—'peoples' privatization' (Braguinsky, 1998, p. 231)—had not materialized, nor had the dream of 'people's capitalism'. For the transition towards capitalism to succeed, it was essential to gain the support of the managers. Support was gained by allowing management to keep its privileged position and, at the same time, to substantially increase their fortunes despite the 'free distribution of shares' (Weisskopf, 1996, p. 281; Simon, 1999, pp. 1, 2). Control still rested with management, who disregarded the owners of vouchers. They considered vouchers to be inconvenient, as they did not help raise capital but required a dividend payment. In many cases in Russia, managers encouraged workers to buy more shares in the enterprise so as to strengthen their own control, which resulted in the concentration of large amounts of capital in the hands of the few (Smyth, 1998, p. 366; Boycko *et al.,* 1993, p. 169). In Bulgaria, many of the foreign firms were frustrated in their attempts to negotiate with the Agency for Privatization. They turned to the privatization funds and signed contracts where the privatization funds purchased shares in auctions to be sold to these outside interests afterward. While these forward contracts could not be enforced in court, there is every indication that these contracts were honoured (Miller and Petranov, 2000, p. 237).

Thus, the gains have been captured by the managerial class, who have successfully won rents from the state in the form of privatized enterprises, state subsidies, credits and tax evasion. These rents effectively removed revenue from the state that could have been used to support social policy during transition and especially pension reform. Nevertheless, pension reform could have had encouraged restructuring (Kapstein and Milanovic, 2000, p. 29). One of the fundamental trade offs of incentive theory was applicable here: the presence of informational asymmetries gives rise to a trade-off between rent extraction and efficiency. The government must pay substantial rents to the local agents if it wants privatization to be implemented swiftly (Friebel, 2000, p. 38).

The transition economies lacked private capitalists with the necessary financial capital to purchase enterprises, making foreign ownership the only alternative. It was not by coincidence that foreign capital came to the rescue of transition economies. This was an act of purposeful action by the mature market economies, ensuring that foreign ownership was the only permissible medium of privatization. A process, like shock therapy, implicitly had the goal of initiating the destruction of any institutional barrier inhibiting the penetration, influence and power of foreign capital. The International Monetary Fund and the World Bank were responsible for creating the depression in transition economies through the collapse of domestic markets and COMECON, the development of the hard

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budget constraint, and the provision of foreign aid conditional on satisfying specific 'shock therapy' targets. In such an environment, the only interested buyers come from abroad at a price 'for next to nothing' (Gowan, 1995, p. 45). There was 'a brutal struggle to steal everything they could get their hands on' (Holmstrom and Smith, 2000, p. 7). For example, in Hungary, foreigners dominated the purchase of state assets. In 1991, 85 per cent of the 40.1 billion forint of privatization revenue came from foreign investors (Samonis and Hunyadi, 1993, p. 38; Jarai, 1993, p. 80). Equally important was the pressure exerted on governments from transition economies to sell state assets and public utilities to multinational companies (the only possible buyers) to reduce fiscal deficits, lower inflation and discipline the labour market by inducing high unemployment. Effectively, multinationals practiced 'cherry-picking' in the name of global integration and national disintegration (Radice, 1993, p. 10). Packages of incentives and legal regulations were often negotiated on a case-by-case basis, making the process appear arbitrary and even corrupt (Smyth, 1998, p. 366). As Bucknall (1997, p. 8) stated, 'it must be great fun remaking nations, a chance few ever get, and it must be even better when it is personally profitable'.

5 RESTRUCTURING VERSUS PRIVATIZATION

Did the private owners of the newly privatized enterprises restructure the firms? Carlin *et al.* (1995, p. 450) concluded after a study of 450 newly-privatized enterprises in the Czech Republic and Slovakia, Hungary Poland and Russia between 1990 and 1993, there was little evidence that privatized enterprises were more likely to restructure than state-owned enterprises. Djankov and Kreacic (1998) by using 4 case studies and a survey of 92 manufacturing firms in Georgia over the 1991–96 period, found that privatization did not affect restructuring, instead import competition was associated with improvement in enterprise performance. As well as evidence that a vast proportion of Russian economic activity is carried out through barter, enterprise arrears and tax arrears in a non-cash economy of unrestructured enterprises provides strong evidence against the sufficiency of privatization for restructuring (Gaddy and Ickes, 1998). Consequently, Kolodko (1999, p. 11), Stern (1996, p. 8) and Aghion *et al.* (1994) concluded there is no clear evidence that the privatized enterprises perform better than the state enterprises just in the aftermath of privatization. Based on their findings they suggested that restructuring, rather than privatization, should had been put at the centre of the analysis of enterprise sector reform.

In relation to whether restructuring should precede privatization, the answer was clear for the post Keynesians. They believed it was the responsibility of the government to use discretionary measures to ensure the viability of the enterprises before and after privatization. The government should assist and equip enterprises with the essential internal structure necessary to survive the competitive market process (Davidson and Davidson, 1996, p. 215). 'Governments do not kill state enterprises when they are inefficient. They subsidise them, 'modernise' them, 'preserve jobs' in them, protect them from 'unfair competition', assure them 'fair profits'—in a word nurse them rather than kill them' (Frydman *et al.*, 1997, p. 85). Moreover the maintenance of state enterprises facilitated the development of a civilized society, since the transition would not necessarily involve a massive increase in unemployment. As Bucknall (1997, p. 12) proposed, 'the Russian experience suggests that privatization first is not the best way to proceed'. Pinto *et al.* (1993) found that many Polish state-owned enterprises began

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reforms early in transition without being privatized. Restructuring before privatization seemed to have met with some success in both Poland and Russia's small shops (Fischer and Sahay, 2000, p. 19).

Post Keynesians viewed labour-managed firms favourably as a means of restructuring state enterprises. This was because labour managed firms are democratic which enhances workers' loyalty and commitment resulting in positive effects on labour productivity (Targetti, 1992, p. 13). Post Keynesians believed worker motivation would have been increased to make enterprises efficient and profitable, at the same time mobilizing support for the transition process. Labour-managed firms would have required government financial assistance and an appropriate institutional structure so that they would not be disadvantaged. In such circumstances, labour-managed firms could have become a transitional mechanism allowing people gradually to adjust their behaviour with maximum participation. 'This [labour managed firms] seems to be the only feasible way to make the inevitable process of social transformation more stable and fair' (Bin, 1992, p. 190). It was up to the reformers to exploit and further develop the existing co-operative property structure. This can be achieved by free distribution of shares to the workers. This is in contrast to the neoclassical privatization policy of free distribution of shares to the whole population.

In contrast, Lipton and Sachs (1990) and Frydman *et al.* (1999, p. 1169) argued that the drawbacks of labour ownership are more or less universally recognized, thus ownership by labour in transition economies would had resulted in the perpetuation of inefficiencies. Havrylyshyn and McGettigan (1999, p. 24) argued that the aforementioned argument has been validated by most of the empirical work in transition economies. It appears that insider privatization and particularly labour-managed firms, generally led to poorer performances than in cases of outsider privatization (EBRD, 1999, p. 33; Havrylyshyn and McGettigan, 1999, p. 26). Moreover, the literature identifies new firms as being clearly the best performers, followed by outsider-dominated firms, while insider-dominated firms are the least efficient (Havrylyshyn and McGettigan, 1999, p. 1; Djankov and Murrell, 2000, p. 37; Frydman *et al.*, 1999, p. 1153). Nevertheless, as already mentioned labour-managed firms required government financial assistance and an appropriate institutional structure so that they would not be disadvantaged, which even The World Bank (2002, p. 71) recongnized. Earle and Estrin (1996), Shleifer and Vasiliev (1996) and Uvalic and Vaughan-Whitehead (1997) validate the proposition that under certain conditions associated with finance and institutions, management–employee buyouts could result in more efficient outcomes.

The transfer of state property to financial intermediaries or investment funds was another alternative to outright privatization, which facilitated restructuring, subject to the specific characteristics of the firm and the general economic conditions. The advantages were that it was less time consuming and people with specialized skills would be in charge. However, the empirical evidence reveals negative performance outcomes by investment funds. Ownership by the Ukrainian investment funds and holding companies does not have a positive effect on performance (Pivovarsky, 2001, p. 4). In the Czech Republic the designers of mass privatization gave the large state banks permission and encouragement to set up investment funds. Gray (1996, p. 6) argued that it would be counterproductive in the long run given the high concentration of economic and political power that has resulted in the hand of a few banks and funds themselves linked to government through formal and informal ties. However, this outcome could only be associated with an inadequate legal and regulatory environment (Pivovarsky, 2001, p. 9), which has discouraged a managerial

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behaviour motivated by civic values and exercising civilized leadership. But it is notable that investment funds are significant better than foreigner ownership (Djankov and Murrell, 2000, p. 38).

Actual privatization, hardened budget constraints and product market competition appear to be important determinants of enterprise restructuring in Central and Eastern European countries, while they are less effective in the CIS. As well, privatization to labour in the CIS has been worse than state ownership (The World Bank, 2002, p. 71). The difference in impact of privatization between CIS and Central and Eastern Europe is due to the varying degree of institutional development (Djankov and Murrell, 2000, p. 69). Blanchard and Kremer (1997) have claimed that the absence of contract enforcement mechanisms was a primary factor causing the dramatic fall in output during transition in the CIS. From the evidence gathered labour and diffuse individual ownership is more prevalent in the CIS than in Central and Eastern Europe. While foreign, investment fund, concentrated individual and bank ownership is less prevalent. The types of owners that require substantial institutional assistance have received less support from institutions in the CIS than in Central and Eastern Europe. Thus, a critical factor explaining the smaller effect of privatization in the CIS is the large share of labour ownership, arising in an environment where the institutions did not provide fertile ground for labour managed firms to be effective and viable (Djankov and Murrell, 2000, pp. 41–42). Thus, since the CIS has an ownership portfolio that contains a greater share of labour managed firms in an inadequate institutional environment, the structure of ownership explains the underperformance of newly-privatized firms in the CIS (Djankov and Murrell, 2000, p. 39). Pivovarsky (2001, p. 9) argued that the interaction of ownership concentration and enterprise performance in the CIS might explain, at least in part, the evidence that privatization was not successful in the CIS countries as it was in the advanced transition economies. Meanwhile, Belarus, Turkmenistan and Uzbekistan maintained continuing reliance on centralized political power and mechanisms of administrative control inherited from the command economy. These countries have managed to maintain discipline over managers in state enterprises without liberalization or hard budget constraints and limit extensive asset stripping and other forms of theft at the enterprise level (The World Bank, 2002, pp. xviii, 33). Djankov and Murrell (2000, p. 5) meta-analysis of the results of 35 distinct studies revealed that state ownership within partially-privatized firms is effective, producing more restructuring than enterprise insiders, workers, and diffuse individual ownership and matching the restructuring produced by managers and banks.

It is obvious that there is mismatch between the institutions of investor protection and the ownership structure that emerged after privatization in many transition economies (Pivovarsky, 2001, p. 6). Such arguments, as presented in this paper, illustrate clearly that in order to foster the emergence of an effective private sector, not only is the implementation of a well-designed privatization strategy important, but the institutions are also vital. It is tempting to conclude that the general market and competition environment is much more important than privatization as such, and the method of privatization. Havrylyshyn and McGettigan (1999, p. 36), and Anderson *et al.* (2000) were in agreement with these statements. In sum, the task of privatization is not merely one of changing ownership *per se*. Rather it involves changing an entire socio-economic system by creating the many institutions required in a market economy to enable owners to exercise full ownership rights and corporate government responsibilities (Gray, 1996, p. 8). For example, in Bulgaria establishing effective institutions for governance of large enterprises remains one of the major challenges of the transition (Miller and Petranov, 2000, p. 249). In Ukraine

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the institutional environment is not conducive to the protection of investors—both foreign and domestic—and exacerbates the agency problems associated with disperse ownership (Pivovarsky, 2001, p. 21). Consequently, 'the pace of privatization should not outrun the development of adequate supervision authority' (The World Bank, 2002, p. xxxi). The empirical literature suggests that when effective institutions are lacking, costly substitutes emerge in their place and asset stripping theft, and other violations of property and shareholder rights become widespread (The World Bank, 2002, p. xvii; Djankov and Murrell, 2000, p. 6). Conversely, institutional innovations can help to moderate the damaging effects of less-than optimal policies (Djankov and Murrell, 2000, p. 67), including privatization.

6 CONCLUSION

Nowadays, the early emphasis on fast privatization is subject to intense criticism (Stiglitz, 1999). For the post Keynesians, there could have been a transition to a market economy without a substantial change in property ownership. This was because ownership, as such, was less important than competition, the incentive structure and the nature of regulatory policies (Gustafson, 1999, p. 57). There would have been no gain to society if state enterprises were replaced by private monopolies. This would have exacerbated the situation by substantially increasing prices, reducing output and increasing unemployment. There was a need for the government to play an active role in the market process, due to extensive market failure. Thus, restructuring and establishment of the regulatory framework had to precede privatization. However, 'some critical minimum of property rights' reform may have to be undertaken quickly, for democracy without a solid market economy is unthinkable' (van Brabant, 1991, p. 35). Post Keynesian methods of privatization would have incorporated free distribution of shares to the workers and/or the transfer of property rights to the financial intermediaries. Efficiency and equity would have guided the process and this would have only been possible through distribution of free shares to the workers. The government would have required retaining a percentage of shares as a source of revenue, with the balance going to pension funds in order to finance retirement benefits. Such an exercise would have attracted political support from the people. In addition, free shares to the workers and the establishment of labour managed firms, would have provided them with a financial incentive to restructure their operation into a more efficient one based on their 'inside' knowledge.

The privatization policies recommended by post Keynesians could have resulted in a substantial smaller reduction in output and employment and a substantial smaller increase in inflation. This is because the privatization process would had been postponed for some future date, after the establishment of an effective institutional structure encouraging a civilized society. The establishment of an institutional structure in accordance with the ultimate goal of a civilized market capitalist society must precede privatization; otherwise, as the transition experience revealed, privatization would be ineffective and encourage wealth accumulation with illegal means. Thus, the post Keynesian policies of privatization would had resulted in a substantially smaller social cost of transition than the privatization policies imposed by the World Bank and the IMF by implementing the neoclassical model. This is because the privatization policies recommended by the post Keynesians involved a substantially smaller change in property structure and more emphasis on incentives, regulations and the institutional structure.

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