Industriens Utredningsinstitut
THE INDUSTRIAL INSTITUTE FOR ECONOMIC AND SOCIAL RESEARCH

A list of Working Papers on the last pages

No. 339, 1992

A NOTE: ON PRIVATIZATION, CONTRACT TECHNOLOGY AND ECONOMIC GROWTH

by

Gunnar Eliasson

Note to appear in Day–Eliasson–Wihlborg (eds.), 1992, **The Markets for Innovation, Ownership and Control**, IUI and North-Holland, from a conference held at Saltsjöbaden, June 12–15, 1988.

September 1992

Postadress
Box 5501
114 85 Stockholm

Gatuadress
Industrihuset
Storgatan 19

Telefon
08-783 80 00
Telefax
08-661 79 69

Bankgiro
446-9995

Postgiro
19 15 92-5

2.92 10.000

A Note
On Privatization, Contract Technology and Economic Growth

What we can learn from East European privatization and what they can learn from Western contract technology.

Gunnar Eliasson

In their 1973 book on *The Rise of the Western World* North–Thomas observed that by the early 18th century, the institutions needed for viable markets, notably those defining and enforcing property rights, were all in place in Western Europe and in the United States. The industrial revolution "could" start.

The idea that particular institutions are needed to facilitate trading in dynamic markets dates back still further to Commons (1924), Baumol (1952) and Downs (1957), but in those days nobody paid attention. This idea is a recurring theme in several of the papers of this conference, a notable fact considering the almost complete absence of such considerations in economic theory only a few years ago. Again, however, also the role of institutions have to be modeled with care to make economic sense. And as it happens, the frantic attempts in destroyed East European economies to establish orderly, privatized markets to get the industrialization process going, provide thoughtful illustrations to the base theme of this conference.

Among other things Eastern European economies lack the financial market institutions needed to establish *tradability*. If ownership to the item to be traded cannot be properly defined and identified then voluntary trade is not possible.

Moreover East European firms – to the extent they can be said to exist as autonomous decision entities – lack the competence to produce competitively for Western markets. They have to *learn* to develop competitive products, to produce them efficiently and to market them successfully.[1] All

[1] See Eliasson (1991b).

these are characteristics of Western market economies which have been taken for granted. Economists often assume – when discussing real events – that firms always operate on the efficiency curves. The East European situation shows very clear examples that operate far below their capacities. And even if operating at their potential capacity levels, they would still be far below even average Western standards.[2] But learning to achieve Western standards is a resource intensive process. Such learning won't take place effectively unless the appropriate *incentive system*, or *contract technology* be instituted.

The Contract Technology Needed for Efficient Financial Markets

The contract technology I am talking about is the institutional framework that allows successful learners to capture for themselves a reasonable share of the rents they have created. This is the gist of the privatization issue in formerly planned economies. Privatization demands more fundamental change than the mere formal transfer of ownership from state to private hands, which is sometimes thought to be all that is needed to create a market economy. This observation takes us back to the theme of this conference; the real role of dominant, dynamic financial markets. Day argued that without the proper financial institutions resources would not flow efficiently from less to more productive and innovative uses. Lindh surveyed the learning literature and arrived at the conclusion that the concept of learning in economic analysis had to be broadened to be really interesting. Pelikan emphasized the role of the markets for control to allocate economic competence. Greenwald–Kohn–Stiglitz discussed the long-term negative productivity effects of failing equity markets. Wihlborg discussed the contract design that provides low cost and reliable signalling in the equity markets. Glete presented an implicit such contract design in the form of the Wallenberg industrial bank group etc. In my own paper I establish the general "lemons property" (Akerlof,1970) of a stockmarket, that essentially trades in the embodied top level ownership

[2] See op.cit., Eliasson (1991b).

competence to generate future rents. This makes the capacity to learn to be constantly on top in competition the key competence factor in business. Hence it becomes important to ask; *How are markets to be organized and contracts to be designed to maximize the incentives to learn efficiently?*

Tradability in the Entitlements to Future Rents Is What Matters

The most difficult property right of all to identify for market trading is the right to manage the assets, to access its rents, and to trade in the rights to use future rents from investments today. This property right is providing the incentive for learning in a business organization (Eliasson, 1990). Hence, the real role of the equity market in a growth context is to facilitate such learning. The incentives for successful learning of Eastern European firms, thus, hinge critically on these institutional developments. This is so whether we discuss local entrepreneurs or foreign investors, exporting their superior technology.

Tradability is a much stronger requirement than mere privatization. It requires several potential owners, such that no monopoly situation (public or private) exists. If you cannot define the product, ownership cannot be defined and enforced, and tradability cannot be established. Without tradability the value of the product will be considerably lower than in a market where the highest bidder determines the price. Learning of the skills and competences in firms needed for industrializing defunct Eastern European economies will not be stimulated if the returns to such learning are not appropriately jacked up in financial markets for ownership. Privatization in an Eastern European country aimed at establishing tradability in property rights must, therefore, come before other measures, such as opening up markets to competition. Otherwise, the necessary investment in "learning" will not take place. Somehow, this appears to have been forgotten among the outflow of Western advisors to East European countries, who preach competition before the institutions needed to create incentives for production and learning have been established.

has certainly not been realized in modern economic analysis, because of its static nature. This was the reason for organizing this conference. The theme has been touched upon in a fragmented way in several of the papers of this volume where incentives (the Holmström, Campbell etc. papers) or venture markets (Granstrand–Sjölander) are studied. Both Dahmén and Rybczynski, however, convincingly show how the growth potential of an industrial economy is diminished if viable financial markets are not organized such that the growth potential is effectively taken advantage of. Its effective utilization involves exploiting the synergies between the real and financial sectors, which is the same as to say that financial arbitrage be allowed to constantly force reorganization on the real sector through creative destruction and innovation.

This same problem of the West shows up in a more serious form in Eastern Europe, where incompetence prevails in the manufacturing sector and where financial markets and the needed financial institutions are absent.

There are thus a few lessons that can be learned from this little overview, about ourselves and about the Eastern economies.

Is Concentration of Ownership Necessary for Growth?

Equity markets are not only there to provide financing and discipline. As pointed out in Pelikan's paper they are also, and more importantly, there to allocate organizational and entrepreneurial competence[3]. The discipline factor becomes the negative side of competence allocation, through removing incompetence, or financing from badly managed firms, and the only side you see if you filter your thinking through the classical, static model.

To innovate business is, however, a higher level art to accomplish than mere management within the hierarchies of the firm. To do that successfully, strong leadership is needed to overrule internal firm resistance for new methods and approaches. Concentrated ownership makes this possible and also provides the compensation for success (Eliasson 1990), provided

---

[3] Also see Pelikan (1988).

institutions exist that make it possible for competent owners to capture rents that normally accrue with a long time delay. It should also be remembered that business failures will frequently occur.

A successful privatization in Eastern Europe will therefore unavoidably result in the concentration of ownership needed to facilitate change. A huge business lottery will be set up that filters competence to the top and forces incompetence to exit. But only if the contract technology is properly designed will the lottery be biased in favor of business competence, and economic growth.

Is Huge Private Wealth Needed for a Viable Growth Economy?

The other side of this huge and biased business lottery is a very uneven wealth accumulation. Effective markets, however, may eventually reduce excessive wealth accumulation through competition. The interesting policy problem is to find the *optimal order* which leads to a socially acceptable distribution without diminishing economic growth. There is a *minimum of economic freedom* needed for sufficient initiatives to be taken and innovations to occur such that the growth process takes off. In the short run, we will certainly experience a trade-off, making the costs in terms of lost growth in output for a more fair distribution large. I would add as a rather well supported hypothesis (Eliasson 1991c) that in a dynamic, what I call *experimentally organized economy* the optimal organizational mode can only be achieved through gradual experimentation over a very long time. Attempts to improve the economic organization of society on the basis of quick and ready theoretical reasoning are not likely to be very successful. Uneven wealth accumulation will therefore be more pronounced in the Eastern economies than in the West, emerging as they are from a state of enforced disequilibrium. What is even more worrisome is the intermediate state of economic unpredictability that will unavoidably affect individuals during the transition state. The ability of the former, planned nations to weather this transition period politically and socially, without causing reversals back to regulation and planning will determine the long-run success of the economies. These transition consequences are beginning to worry the politicians of the East, and they appear to be used by the former bureaucracy as excuses to impede privatization and change.

Even if huge accumulation of private wealth is a first consequence of a successful transformation, if viable financial markets are established, huge fortunes are never forever. New fortunes are being created all the time and old wealth disappears, if not managed well: But if the situation is such that new fortunes are being created and old wealth disappears, such that the wealth reallocation contributes to growth, the wealth distribution that exists at each point in time is also a consequence of competence being allocated efficiently and properly compensated. This is what will have to be accepted if economic growth is a policy objective.

Some Eastern Economies, But Not All, Will Certainly Pass Us in the Next Generation

What this short story tells is that the potential in the Eastern economies is great, if only the contract technology can be efficiently organized. A viable market organization is a competitive edge in the international growth race among nations, and the financial market organization dominates the performance of the entire economy. The mature industrial nations have not all realized that and have allowed their politicians to interfere excessively with the capital market organization. As a result their economies have began to underperform. About the time of the conference, the economic systems of formerly planned economies of Eastern Europe began to crack. They are now trying to find viable market organizations. The setting is truly experimental. And among the many contestants among the broken-up economic systems, one or two will probably succeed in finding a viable organizational mode. They might even pass many of the currently wealthy, but stagnant nations in a generation or two.

Bibliography

Akerlof, G.A., 1970, The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism, *Quarterly Journal of Economics,* Vol. 84, No. 3 (Aug.).

Baumol, W.J., 1952, *Welfare Economics and the Theory of the State,* Longmans Green.

Commons, J.R., 1924, *The Legal Foundations of Capitalism*, New York.

Downs, A., 1957, *An Economic Theory of Democracy,* Longmans Green.

Eliasson, G., 1990, The Firm as a Competent Team, *Journal of Economic Behavior and Organization*, Vol. 13, No. 3, June.

Eliasson, G., 1991a, Deregulation, Innovative Entry and Structural Diversity as a Source of Stable Economic Growth, *Journal of Evolutionary Economics*, No. 1, pp. 49-63.

Eliasson, G., 1991b, The Micro Frustrations of Privatizing Eastern Europe, IUI Working Paper No. 306, Stockholm.

Eliasson, G., 1991c, Modeling the Experimentally Organized Economy: Complex Dynamics in an Empirical Micro-Macro Model of Endogenous Economic Growth, *Journal of Economic Behavior and Organization*, Vol. 16, No. 1-2 (July), pp. 153-182.

North, D.C. and Thomas, R.P., 1979, *The Rise of the Western World – A New Economic Theory,* Cambridge University Press, Cambridge.

Pelikan, P., 1988. Can the Imperfect Innovation Systems of Capitalism be Outperformed?; in Dosi, G. et al. (ed.), 1988, *Technical Change and Economic Theory*, Pinter Publishers Ltd. London.