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STATE-OWNED ENTERPRISES AFTER SOCIALISM: THE CASE FOR RAPID PRIVATIZATION THROUGH VOUCHERS AND SECONDARY TRADING

Pavel Pelikan*

Handelshögskolan i Stockholm

STOCKHOLM INSTITUTE OF
SOVIET AND EAST EUROPEAN ECONOMICS
Östekonomiska Institutet

Sveavägen 65 - Box 6501 - S–113 83 Stockholm - Sweden

ÖSTEKONOMISKA INSTITUTET
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Pavel Pelikan*

* Research Associate, Industrial Institute for Economic and Social Research, Box 5501, S-114 85 Stockholm. This paper benefited from valuable comments from Olivier Bouin, Irena Grosfeld, Luisa Giurato, Richard Langlois, and Xavier Richet.

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Stockholm Institute of East European Economics
Stockholm School of Economics
Box 6501
S-113 83 Stockholm Sweden
tel. (46-8) 736 96 70 fax (46-8) 31 64 22

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1 Introduction

There is still much disagreement about how to transform and redress the economies impoverished by several decades of real socialism. Perhaps the greatest disagreement is about the privatization issue. While virtually everyone now seems to agree that markets are superior to central planning and that macroeconomic stabilization is necessary, opinions widely differ on what to do with the ownership of the great number of state-owned firms. Although in several of these economies, different programs for transferring these firms into private hands are already at work, the programs result more from ad hoc political decisions than from systematic economic analysis. On the other hand, there are also post-socialist economies where most of such firms still remain in state ownership, with no concrete decision on their privatization in sight.

The fundamental cause of this disagreement, I contend, is the lack of a clear and generally recognized theoretical reason why firms should be owned privately. Many theoretical economists still doubt whether privatization is at all necessary. Some even argue that reasonable efficiency can be achieved with an improved form of state, communal, or employee ownership of firms, and thus revive hopes that some kind of real market socialism might still be feasible.[2] It is also frequent to see privatization as a purely ideological issue. Of course, without the knowledge of how privatization could be justified economically, the only visible reasons for it must be ideological. The political demand for privatization that can be observed in many post-socialist countries is then seen as an emotional reaction of local populations to the many years of painful experiments with the wrong kinds of socialism. In consequence, many theoretical economists respect this demand as good democrats, but not as economists.

The lack of clarity about why to privatize cannot but cause disagreement about the extent, the speed, and the methods of privatization. For example, inspired by the Chinese reform, some economists argue that the private sector should be allowed to

[2]An interesting recent design for real market socialism is in Bardham and Roemer (1992) and its refutation is in Pelikan (1993). The adjective 'real' is used to distinguish market socialism which uses real markets, without any central planner, from socialist planning that imitates markets along the lines suggested by Oscar Lange, sometimes also called 'market socialism'. Whereas the latter was refuted by Friedrich Hayek and no one now seems to take it seriously, real market socialism is more difficult to refute and still appears to have enthusiastic supporters.

grow, but the existing state-owned firms should not be privatized.[3] Those who do agree that these firms should be privatized disagree on other questions -- such as how fast this should be done; whether privatizing should precede or follow restructuring; how much, if anything, should be privatized by means of freely distributed investment vouchers; and how much to rely upon emerging financial markets as opposed to large banks and institutional investors. There are even sophisticated mathematical models, based on the assumption that the only reason for privatization is political demand, which show that to meet this demand optimally, privatization should not proceed fast.[4]

The main purpose of this paper is to show that there *is* a strong economic argument for rapid privatization, which moreover throws new light on alternative privatization methods. The argument is based on my earlier study of the role of scarce economic competence in the evolution of firms and industries.[5] Among other things, the argument explains why privatization should precede restructuring, and brings strong support to a certain type of privatization by investment vouchers, which theoretical economists usually reject.

The paper is organized as follows. Section 2 recalls the definition of scarce economic competence and exposes its most important properties. Section 3 explains why careful examination of the economic competence involved is essential for a good understanding of the privatization issue. Section 4 summarizes the competence argument for private and tradeable ownership of firms. Section 5 shows what this argument implies for the speed and the sequencing of post-socialist privatization, and Section 6

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[3]An example of this argument is in Nolan (1993). It is easy to see why this argument is of little general interest. State-owned enterprises in China are about as mismanaged and wasteful as in other socialist economies. The subsidies they require substantially contribute to the high Chinese inflation. The only advantage of China is to have relatively few of them. It is because of their relatively low share in the Chinese economy that they can be tolerated, as a residue of socialist waste in the midst of growing capitalist production. But this is clearly not the case of the highly but wrongly developed post-socialist economies in Europe, where state-owned firms had virtually all of the available scarce resources under their control.

[4]An amazing example of this kind of exercise is in Katz and Owen (1993). Their basic assumption is that privatized firms do not perform better than state-owned firms, but cause unemployment. Their model then tries to find an optimum path between the negative political effect of this unemployment and the positive political demand for privatization (which, according to the assumption, must be considered entirely irrational). The result is an astonishing curve in which the optimal speed of privatization varies in an intricate fashion.

[5]For the main results, see Pelikan (1992, 1993). The ones relevant to the privatization issue will be here recapitulated, to allow independent reading of the present paper.

examines the choice of the privatization method. Section 7 consists of concluding comments.

2 Economic competence as a scarce resource

The starting point is a simple observation. What an economic agent does depends not only on his incentives and available information ('data'), but also on his competence ('rationality') to use the information in responding to the incentives. While the incentives and the information have been frequent subject of economic analysis, the problem of competence has mostly been neglected. Much of this problem is indeed hidden by the standard assumption of perfect rationality, which postulates that each agent uses the available information optimally (the Optimization Postulate).

To see the competence problem in its entirety it is indeed necessary to drop the assumption of perfect rationality. The direction to follow is indicated by Simon (1978), who argued that human rationality is bounded, and by Heiner (1983), who considered such bounds in relation to the difficulty of the problem to be solved, and introduced the notion of *competence-difficulty gaps*. To see also the social dimension of the competence problem, however, we must go even farther. Whereas Simon and Heiner are concerned with competence constraints on one-person problem-solving (decision-making) *in general*, the study of resource-allocation in society must consider such competence as an *agent-specific scarce resource*, of which different agents may possess different quantities and qualities. This means to admit, in Simon's terms, that the rationality of different agents may be bounded in different ways and degrees, or in Heiner's terms, that for a decision problem of given difficulty, different agents may suffer from differently wide and differently shaped competence-difficulty gaps.

To denote this resource, a suitable term appears to be 'economic competence' (EK). EK thus has the meaning of the competence of economic agents to recognize and use relevant information for solving economic problems and taking economic decisions. In other words, EK refers to what is often called 'optimization abilities' or 'rationality'.

Much like any other scarce resource, EK raises the problem of its efficient allocation in society. For EK, however, this problem turns out to be more intricate than for any other scarce resource. Although EK has some common features with economic information and human capital -- scarce resources whose allocation has been fruitfully studied by standard means -- it differs from both in ways that makes standard analysis of its allocation impossible. Whereas economic information is assumed to be (possibly at a cost) communicable, economic competence is a kind of tacit knowledge which for each agent can have only two sources: own initial endowment and own learning, which in turn must be based on own initial endowment with learning competence ('talent'). Although this makes economic competence resemble human capital, the crucial difference is that the human capital that standard theory admits to be scarce includes competence in all domains, but not in economic decision-making itself. To admit that also this competence may be scarce leads to a paradox which breaks the theory.[6]

EK resembles human capital on one more point -- namely, by its heterogeneity. It can be classified into many different categories according to the type of the decision problems for which it can be used. Different agents may be endowed with different amounts of EK of different categories, so that a simple ranking of agents according to their quantity of EK is not always possible. For example, one agent may have more EK for accounting under certainty, another one may have more EK for estimating probability distributions under risk, and a third one may be particularly competent at complex problem-solving under uncertainty. EK is thus not only agent-specific, but also problem-specific. If the assignment of a certain problem to a certain agent causes a very large competence-difficulty gap, the implication need not be that the agent is incompetent; his competence might still be high, but, from the point of view of the problem, of the wrong kind.

For the present purposes, as will be explained below, it will be of particular importance to distinguish EK for managing (sometimes called 'managerial talent') from EK for owning, which includes the competence for recognizing and employing competent managers, but not necessarily the competence for managing itself. Moreover, both these kinds of EK will be important to distinguish from the politico-administrative competence

[6]The paradox is exposed in Pelikan (1989: 284). To see it, consider an imperfectly competent investor which is to optimally invest in further study of economics of investment, in order to become a better investor. The paradox is that to take the optimal investment decision now, he would need the competence which he is seeking to acquire in the future. That no such paradox arises for other kinds of competence is instructive to note. For example, an imperfect engineer who invests in further study of engineering can very well do so optimally. All he needs is to be a perfect investor -- which is indeed what the human capital theory assumes him to be, as a corollary of the Optimization Postulate on which the theory is built. The economic competence of investors is a singular resource: to admit its scarcity breaks the theory.

needed for a successful career within the state and/or party bureaucracy.

Before considering these types of EK in more detail, however, it is important to note a few general properties of EK-allocation. First, it is on this allocation that the efficiency of the allocation of all other scarce resources crucially depends. This expresses the rather obvious but in standard analysis neglected truth that the performance of an economy crucially depends on the competence of the agents that assume there the key decision tasks -- in particular those concerning production investment, industrial strategies, organization and management of firms, and economic policies.

Emphatically, this does not make incentives unimportant. Efficient EK-allocation alone, without appropriate incentives that would make relevant competence work in socially efficient ways, would clearly be insufficient. The present point only is that also the best incentives would be insufficient if not accompanied by efficiently allocated EK. Enormous social losses are often caused by correctly motivated agents who are incompetent, or competent about the wrong things.

Second, because of its tacitness (incommunicability), EK-allocation requires changes in the organizational structure of the economy (restructuring). This makes it intimately tied to the evolution of this structure (including entry, exit, and reorganization of firms and industries) and organizing processes in general. It is by creating, modifying, or abolishing decision tasks and/or by replacing the agents that perform them that this allocation proceeds. EK-allocation thus raises the double problem of both organizational design and job-assignment, with the further complication -- and this is what makes it so intricate -- that neither the designers nor the assigners are a priori given, but also their jobs must endogenously be designed and assigned as part of this special allocation process. This introduces into EK-allocation elements of path-dependency and the appearance of infinite regress.

Finally, what further complicates the problem of EK-allocation is that there is no easy way of measuring EK -- other than its actual performance, which usually becomes known only after a long delay, when costly errors may have already been committed. To asses in advance an agent's EK, *including one's own*, and find for it a suitably difficult and useful decision task is itself a difficult decision task, which requires much of EK if costly errors are to be avoided. In other words, EK is also needed for assessing and allocating EK, which introduces into EK-allocation elements of self-reference.[7]

Given all these complications, it is understandable why EK-allocation has not become a popular subject of economic analysis. Western theoretical economists have moreover a good excuse for neglecting it. In their home economies, although unnoticed by standard static analysis, market selection has done a reasonably good job at correcting the most serious cases of EK-misallocation, and thus making them difficult to observe. In consequence, Western economists have had hardly any reason to believe this problem important. Friedman (1953), in his famous justification of the Optimization Postulate, explicitly refers to market selection as a means of making all surviving agents, in the long run, reasonably respect the Postulate.

In the study of socialist and post-socialist economies, however, this excuse is no longer valid. There, market selection has been for a long time absent, which allowed even gross EK-misallocation to last. All socialist economies -- and, for that matter, also the state-owned firms within mixed economies -- suffer indeed from tendencies to allocate inadequate EK to over-ambitious economic decisions, *and allow such misallocation to last without effective corrections*. The post-socialist economies, which could not but inherit these misallocations, had thus to start with many top economic positions wrongly designed and occupied by inadequately competent people.[8] The success of the entire post-socialist transformation now depends on how fast and how well these misallocations will be corrected. What is thus urgently needed is to start an effective *process* for making such corrections and for preventing further misallocation of economic competence from occurring *and lasting*. It is by examining alternative forms of ownership of firms for their role in this process that some strong conclusions about

[7]That correct assessment of own EK also requires high EK should be properly noted. While competence differences begin to be studied, it has become common, because of mathematical convenience, to assume that each agent knows at least his or her own competence. It is well known, however, that people often misjudge their own capacities, and incompetent people in particular are often unable to see how incompetent they are. This is indeed an instructive example of how mathematical convenience can make analysis blind in theory to what may cause important social losses in practice.

[8]To avoid misunderstanding, let me emphasize that this does not mean that these people are incompetent in general. They must be highly competent, for otherwise they would not have been so successful. I only claim, as will be explained in more detail below, that from the point of view of social efficiency, their competence is likely to be about the wrong things. They are certainly competent about making career in the party or state administration, but not necessarily about organizing and managing firms, or deciding on industrial strategies.

post-socialist privatization will be possible to reach.

The emphasis on 'process' and 'lasting' deserves a comment. It is important to realize, as will be discussed in more detail below, that in the short run, no form of ownership can prevent EK-misallocation from occurring. No privatization method can guarantee that the right owners will immediately be found. To ignore this leads to disappointment and can be used for demagogic arguments against privatization. An important point of the present argument is that forms of ownership must be regarded as institutional frameworks which allow more or less powerful correction processes to take place. It is in preventing EK-misallocation from lasting, rather than from occurring, that alternative forms of ownership will be found to differ the most.

3 Scarcity of economic competence and the privatization issue

Let me first clarify why the privatization issue cannot be settled by analysis of incentives alone. At first sight, when interpreted by already convinced believers in private enterprise, such analysis may indeed appear to clearly support private ownership of firms. The popular argument is that non-owners have weaker incentives than owners to organize and manage a firm efficiently. This means that they must be expected to work less hard and misuse the firm's assets for their personal rent-seeking (see, e.g.,Buchanan et al., 1980; and in the context of post-socialist economies, Winiecki, 1991).

Upon a closer examination, however, this argument proves to have several weaknesses, which can strengthen the case *against* privatization. To begin with, it can be pointed out that in a modern capitalist economy, most of the important decisions within large firms are taken by non-owners, while the owners remain passive. Following Jensen and Meckling (1976) and Fama (1980), the assumption of passive owners is indeed central to most of the modern literature on corporate control. An opponent of privatization can then successfully argue that who owns firms does not matter, only the quality of management does.

Analysis of incentives can also be used to strengthen the case for government ownership of firms by two theoretically interesting arguments. One consists of the well-known incentive-compatible schemes which, under standard assumptions, can motivate also non-owners to signal truthfully and act efficiently. For example, a variant of this argument is now used by opponents of privatization in Poland, who claim that state-owned firms can be made efficient by means of suitable incentive-compatible contracts between the state and the managers. Under the standard Optimization Postulate, which assumes that all the state administrators involved are perfectly competent to choose the right managers and to design, conclude, and monitor such contracts, this claim can hardly be refuted.

The second argument combines agency theory with analysis of rational political voting. The theory exposes the difficulties in achieving efficiency in private firms where ownership is separated from management -- as is the case of most large firms in modern capitalist economies. The analysis then shows that a firm owned by a democratic government, where assumedly rational voters play the roles of assumedly rational stockholders and where the Board of Directors consists of politicians submitted to regular re-elections, can cope with these difficulties at least as well as a private corporation (Wintrobe 1985). More fundamentally, the importance of economic incentives themselves may be put in doubt by pointing to cases of successful cooperation in teams -- such as a kibbutz, a university, or an army -- where solidarity and loyalty appear more important. That the privatization issue cannot be settled by analysis of incentives alone thus clearly follows.

To introduce into the privatization issue the scarcity of economic competence, it is sufficient to consider only a few kinds of the most important decision tasks (positions) on the supply side -- in particular those of the managers and the owners of firms (including banks) and the government policy-makers -- and the corresponding kinds of EK. For efficiency of EK-allocation -- which, as noted, is the key to the efficiency of the entire economy -- a necessary condition is that these positions be suitably difficult and provided with adequate EK. More precisely, these positions must neither cause socially costly competence-difficulty gaps -- by being allowed to grow too difficult and/or remain assigned to inadequately competent agents -- nor waste scarce high EK by being kept too simple, and thus forgoing economies of scale and other advantages of modern industrial organization.

The study by Lucas (1978) of the relationship between managerial talents and the sizes of firms is a convenient point of departure. To recall, Lucas develops a simple formal model of the idea, due to Manne (1965), that a firm's performance depends on the talent of its manager, and that this talent is scarce and unequally distributed in the population. Assuming a simple production function in which the manager's talent is a parameter, Lucas shows that a given distribution of managerial talent implies an optimal size distribution of firms that maximizes the total output from given labor and capital. The obvious necessary condition is that the firms of different sizes be correctly matched with managers of corresponding talents: the most talented manager must lead the correspondingly largest firm, the next best manager, the second largest firms, and so on, until the last marginally talented manager, leading the smallest firm, fills up the production capacity; those who are even less talented for managing than this last manager are employed as labor in one of these firms. That the model is about a case of EK-allocation is easy to see. The decision tasks to be designed and assigned are those of the managers (chief executives) of firms, the difficulty of which depends on the firm's size, while the competence with which it is performed depends on the talent of the appointed manager.

Of course, the problem studied by Lucas is extremely simplified, in order to allow for a mathematical solution. But in each real economy, this problem arises in a non-simplified form, for which it is necessary to find a real solution. The sizes of all firms -- taking into account not only the volume of their production, but also their complexity, and the complexity and the variability of their environments -- must somehow be determined and their managers somehow selected and appointed. This is, in the present terms, the problem of EK-allocation to management. As noted, this is the double problem of how to design the managerial jobs -- which depend, among other things, on how large and how complex the firm is allowed to grow -- and how to assign these jobs to specific managers.[9] The fundamental point, on which the entire present argument reposes, is that the performance of the entire economy crucially depends on how well, or how poorly, this double problem is solved.

As this fundamental point is seldom properly seen by theoretical economists, additional comments are in order. In standard economics -- and this is why this point

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[9]A truncated version of this problem is addressed by Sah and Stiglitz (1985). They assume that all the managerial jobs are already designed (which presupposes a fixed population of firms of fixed dimensions) and assigned to managers of a first generation. Their study is limited to how these managers should select their successors, assuming the owners away. It is of course true that incumbent managers sometimes succeed in extending their jobs to decisions on both the growth of firms and the choice of their successors. But, as will become clear in a moment, this can only happen is the owners allow it to happen.

is so rarely seen -- the double problem of EK-allocation is simply assumed to be already optimally solved. The common assumption in most theoretical analysis of both markets and planning is indeed that all the firms involved are productively efficient and always able to optimize -- be the firms capitalist or socialist, and be the optimized variables profits or plan indicators. Obviously, an implicit part of this assumption must be that all firms are of the right dimensions and are managed by perfectly competent managers. Whatever inefficiencies might plague the economy, their only causes must be in the *interfirm* allocation mechanisms, which can fail to make such perfect firms efficiently coordinate their activities. The only policy advice then is to change the allocation mechanism. When all efforts to make socialist planning reasonably efficient fail -- as happened in all real socialist economies -- the only policy problem that can be seen is, how to replace planning by competitive markets, which are now recognized to provide for superior resource-allocation. But the form of ownership of firms seems not to matter: if all firms are perfectly organized and managed, social efficiency cannot depend on how they are owned. If equity is valued, avoiding private ownership may even appear advantageous.

However, as close observation of post-socialist economies disclosed in practice, and as the present argument explains in theory, this assumption is grossly false and believing in it leads to costly policy errors. That all forms of socialist planning are highly inefficient as allocation mechanisms is an important truth but not the whole truth. Another, not less important truth is that abolition of private ownership of firms substantially distort the evolutionary process on which the properties of incumbent firms crucially depend. This leads to serious and *lasting* misallocation of EK, as the abolition also dismantles all the effective feedback by which such misallocation could be corrected. As a result -- now confirmed by many empirical observations -- real socialist firms are typically oversized, dimensioned by politicians and government planners, and managed by mostly mediocre managers, selected for their competence to make a political career within the state and/or party bureaucracy, rather than for their EK relevant to industrial organization and management. To replace planning by markets, although necessary, is thus clearly insufficient. The transformation process must also include deep industrial restructuring and regeneration of the population of firms, to make eventually prevail highly performing firms for which the EK-allocation problem has been solved with reasonable efficiency. It is as an instrument of such restructuring and regeneration that massive and rapid privatization is shown here to be indispensable.

To avoid misunderstanding and false expectations, it should be emphasized that EK-allocation is a long-term ('evolutionary') process, which cannot avoid trials and errors. As noted, not all privatized firms can be expected to find the right owners at once, but many subsequent ownership changes may be required. That privatization may not always bring immediate improvement to individual firms, however, is no reason for slowing it down. With it, industrial recovery may take long time, but without it no systematic recovery process can start.

Much of the old criticism of markets was based on the illusion of an omniscient planner, who could easily avoid all market imperfections. Much of today's criticism of post-socialist privatization seems to be based on the illusion of an omniscient state property agency, which can easily see who has the right competence and capital to take care of its firms, and thus avoid the long and costly search for the right owners through market privatization and secondary trading. Without realizing that the second illusion is as absurd as the first, the privatization issue cannot be properly understood.

To see why privatization is so important for long-term industrial performance, we must first find out what the owners of firms have to do with the EK-allocation problem for the firms' managers. The clue is the question, how can this allocation problem be solved. It is the search for the answer that ultimately leads to the owners of firms -- be they private persons, organizations, cooperatives, or governments. It is indeed on the owners that the allocation of EK to management of firms -- which includes, to recall, the selecting of, contracting with, and monitoring the managers, and keeping the size of the firms within those limits that do not overtax the managers' competence -- ultimately depends.

This is true even in cases in which the owners appear passive, having delegated the decisions on the management and the size of their firms to other agents -- such as board of directors, investment funds, or the managers themselves. The reason is, in essence, that all such delegates are subject to the owners' choice, or at least approval.[10] Hence, even if the owners do not decide on the sizes and the management of their firms

[10] A detailed explanation is in Pelikan (1993).

themselves, they still bear the ultimate responsibility for how these decisions are taken. They are the principals who are responsible for both the competence of the agents who take these decisions in their stead and for the incentives by which these agents are motivated to take the right decisions.

That all the delegated agents, managers included, must be both adequately competent and adequately motivated deserves emphasis. The competence problem should not make us forget the incentive problem: both of them must be provided with adequate solutions. But this also have an important implication for the role of owners, and the competence *they* are required to have. As both these problems are difficult and as it is the owners who are responsible for how they are solved, the implication is that *also the owners face difficult and for social efficiency important decision tasks, for which adequate EK is scarce.*

This means that the double problem of EK-allocation, which we just discussed for management, now reappears also for ownership. While there are many similarities between the two variants of this problem, there also is an important difference. For management, the solution of the problem ultimately depends on specific agents of a higher level: the owners. For ownership, in contrast, there are no specific higher-level agents who could be said to solve this problem. How owners' tasks are dimensioned and specific owners are appointed ultimately depends on the institutional rules (such as property rights) that determine who is allowed to own firms -- e.g., which kinds of firms may or must be owned by government, and which kinds of firms may or must be owned privately -- and define the processes by which the ownership of firms can change hands.

The argument of the opponents of privatization that who owns firms does not matter, only the quality of management does, can now be properly qualified. While it is true that efficiency and social welfare strongly depend on the quality of management of firms, this is far from the end of the story. What was just made clear is -- and this is the crucial point -- that the quality of management in turn strongly depends on the competence of the owners: without highly competent owners, it is unlikely that a high quality of management will be obtained and maintained.

The question now is: Which form of ownership of firms makes it most likely that firms will be owned by adequately competent agents, and protected from the inadequately competent ones? It is the study of this question that results in a strong efficiency reason why to privatize, and moreover throws new light on how fast, in which order, and by which methods to do so.

4 Why private ownership of firms[11]

When considered in detail, there are many alternative forms of ownership of firms, which may differ from each other in many ways. For example, forms of private ownership may differ in details of corporate law, bankruptcy law, and antitrust law, whereas forms of government ownership may differ in ways in which the ownership function is divided between the central and local governments, or between elected and administratively appointed bodies. For the present purposes, however, it will suffice to consider only two large classes of ownership forms:

(1) private and tradeable ownership;

(2) government or employee ownership, by definition non-tradeable.

The main proposition to be justified is that (1) is superior to (2) in terms of efficiency and social welfare, largely regardless of what kind of welfare this is chosen to be -- e.g., whether or not income inequalities are to be limited and whether or not consumption of public and merit goods is to be encouraged.

Two points call for clarification. First, when classes of objects are compared, it is important to distinguish what is true about an entire class from what is true only about some of its members. The present proposition about the superiority of (1) should therefore be clarified as follows: *some* members of (1) are superior to *all* members of (2). In other words, it is admitted that (1) may also contain some inferior members -- such as inefficient forms of private ownership of firms which prevent financial markets from developing and/or lack properly designed and effectively enforced bankruptcy and antitrust laws -- and that difficult problems of detailed institutional design may be involved in the search for the superior ones. The essential point of the proposition is that this search should be limited to (1), as only inferior forms of ownership can be found in (2).

[11]This section summarizes an argument that is elaborated in detail in Pelikan (1993).

The second point to be clarified is the relationship to final demand and to different criteria of social welfare. It has often been claimed that different welfare criteria require different forms of ownership of firms. More precisely, private ownership of firms has been claimed to be compatible only with high income inequalities and low consumption of merit and public goods, whereas low inequalities and high consumption of merit and public goods have been seen to require government and/or employee owned firms. These claims, however, turn out to be mistaken. As will be made clear in a moment, the study of econommic competence implies that suitable form of private and tradeable ownership of firms is superior to all forms of government and employee ownership, regardless of the adopted criteria of social welfare. To be sure, the influence of the criteria upon economic performance cannot be denied. For example, it must be admitted that severe limitations of inequality damage incentives and thus diminish the performance. But, as the history of the Stalinist Soviet Union and the Maoist China amply illustrates, this happens regardless of the form of ownership of firms. The competence argument shows that even in such cases, a suitable form of private and tradeable ownership of firms maintains its comparative advantage. In general, this argument is more hospitable to income redistribution than the standard incentive argument: it can be used to show that a mild and suitably designed income redistribution often has positive performance effects (Pelikan 1993: 388-390).

The main proposition can now be justified with the help of two elementary questions:

- Which form of ownership of firms makes it more likely that agents of high competence for owning firms will actually own firms?
- Which form of ownership of firms makes it more likely that insufficiently competent owners of firms will be demoted from this role, and thus prevented from causing unnecessary social losses?

It is easy to show that private and tradeable ownership of firms -- or at least a suitable form of it -- wins on both accounts. One reason clearly appears when we consider the roles that alternative forms of ownership of firms allow product markets to play. Potentially, there are two such roles. One is in determining the prices and the quantities of products of incumbent firms. The second role is in selecting the firms themselves, by setting capital availability constraints on their growth and survival. Whereas standard economics is preoccupied with the first role, it is the second role -- the one pointed out by Schumpeter (1942), Alchian (1950), and Winter (1971) -- that is relevant to the promoting and demoting of owners.

The important point is that product markets can always play the first role, whatever the form of ownership of firms -- and thus also in market socialism -- but not necessarily the second. It is for the second role, which in the long run is much more important than the first, that private and tradeable ownership of firms is essential.[12] It is only with this form of ownership that the most competent owners, who are most likely to obtain and maintain high quality of management, are also most likely to increase their capital and thus be promoted, while less competent owners, who more often tolerate incompetent or disloyal managers, are more likely to lose their capital, and thus be demoted.

That government ownership of firms is inferior in this respect -- be the government democratic or authoritarian -- is easy to show. The crucial handicap of democracy is that the owners of firms are there all citizens, who can be neither promoted nor demoted. Each of them keeps having exactly one vote, corresponding to one share in each of the firms, regardless of his or her relevant competence. In other words, the entire EK-allocation for ownership of firms is blocked and cannot be improved.

Wintrobe's (1985) argument that a democratic government can be as efficient an owner of firms as a collective of private shareholders is thus clearly refuted. Although in such a collective, the allocation of owners' competence may be far from perfect, market selection can nevertheless be expected to increase the voting power of the more competent shareholders -- because of their own intervention in the firm's affairs or because of their choice of competent delegates -- and decrease the voting power of the less competent ones. Hence in the long run, ownership by private shareholders is likely to result in more competent ownership, and therefore more competent management, and

[12]A beautiful discussion of why the second role is so much more important than the first is in Schumpeter (1942), in the chapter on the capitalist "creative destruction". Somewhat surprisingly, however, Schumpeter omitted to examine what happens with creative destruction in socialism. This make him overlook the social value of private ownership of firms and allowed him to arrive at his provocative but mistaken conclusion that socialism could succeed (cf. Pelikan 1987, 1992).

therefore better performing firms, than ownership by a democratic government.

Note that giving the more competent voters only more voice to advise the less competent voters, and not more real voting power, would not help. Why this is so follows from the above-mentioned fact that economic competence is also needed to recognize and efficiently use economic competence. Some little competent voters may simply lack the competence to know how little competent they are and refuse to listen to any advice. Others, who are willing to listen, may lack the competence to recognize competent advice among all the incompetent one that is also likely to be offered.

From this point of view, ownership of firms by an authoritarian or technocratic government appears more hopeful. The top government agents that play there the roles of effective owners can be promoted or demoted in politico-administrative ways, which means that some EK-allocation at the ownership level can take place. The problem, however, is that this EK-allocation is not very likely to be efficient -- significantly less likely than the one implied by private and tradeable ownership of firms and market selection. Politico-administrative selection proves less suitable than market selection for promoting economic competence and, perhaps even more so, for demoting economic incompetence (Pelikan 1987, 1988). The reason is, in essence, that these two selections -- much like tournaments in two different sports -- favor different kinds of competence. The competence that the politico-administrative selection favors most is the one for pleasing political leaders, influential administrators, or strong interest groups, rather than the one for organizing efficient production units and recognizing competent managers. In the absence of private and tradeable ownership of capital, no automatic, impersonal feedback from economic results to the size of the capital controlled can exist. Consequently, errors in the owners' decisions do not automatically cause this size to diminish. Instead, all promotions and demotions must be determined by decisions of specific agents in specific positions within a corresponding politico-administrative hierarchy -- such as a ministry, a government bank or, in a centrally planned economy, the Planning Board. As also these agents had been selected in politico-administrative ways, their competence for correcting economic errors is also likely low, and their appointment to such positions is itself likely to be an error. Even gross errors may thus remain uncorrected and their authors may not be demoted for a long time, possibly not until they cause the entire economy to fall into a deep crisis.[13]

At this point, however, some hope may still be maintained for employee ownership of firms, as this need not entirely prevent the product markets from playing the important second role. Employee owned firms can indeed be exposed to market selection and thus made subject to market determined capital availability constraints on their growth and survival. To show that also this form of ownership is inferior, another reason is therefore required. To see it, we need to extend the study of market selection from the familiar cases of product markets to the still largely unexplored cases of capital markets, including the market for corporate control.[14]

Let me first made it clear that the argument is about the *general* institution of employee ownership imposed upon an entire economy, and not about *particular* firms voluntarily owned by their employees on market terms within a capitalist economy; there can be no objection to the existence of such firms, as long as they are able to cope with their handicap of not being tradeable and keep efficient enough to survive market competition with privately owned firms.

The starting point of the argument is to recognize that selection by product markets -- in spite of its superiority over its politico-administrative alternatives -- is imperfect. Among other imperfections, such selection works only by a combination of complete bankruptcies and waiting for starts from zero of new firms -- both of which may take long time and cause high social losses.

It is by examining how this time and these losses can be diminished that an important drawback of employee ownership of firms and the decisive advantage of private and tradeable ownership of firms can be discovered. While bankruptcies and starts from zero remain important as error-correction of last resort, it is selection by capital markets, including the market for corporate control, that adds another powerful process which can make the correction both smoother and cheaper. In this process, the

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[13]A possible objection is that government could appoint some highly competent winners of market competition to take care of government ownership. The hurdle is that market competition is a continuing process open to entry of new talents and forcing the exit of declining old winners. As government appointments interrupt this process, the competence of the appointed winners might soon relatively or absolutely decline, without triggering effective corrections.

[14]An attempt of mine to understand this kind of selection is in Pelikan (1989). The following discussion recapitulates the main points of this attempt.

agents to be selected are the exceptionally competent owners of capital, who are able to perform the socially valuable function of distinguishing future winners from future losers.[15] They can then make the selection of firms both faster and cheaper by providing necessary competence and capital to the former, and accelerating the exit of the latter. That the process must allow for changes of ownership -- e.g.,through buy-outs or take-overs -- is important to note. It is these changes that form an important additional channel for error-correction. Thanks to them, not all declining firms need go entirely bankrupt; at least some may be saved in time, when efficient reorganization is still possible.

In this respect, employee ownership of firms proves inferior for two reasons. First, it only allows for the slower and costlier selection by product markets, but not the one by capital markets. This decreases the probability of selecting agents of the right competence for the highly difficult task of capital owners. This task must be there assumed by government banks or industrial policy-makers, whose handicap is their origin in a politico-administrative selection. Their relevant competence is thus likely to be low and the social costs of the errors they will commit -- e.g.,by mistaking future losers for future winners -- will likely be high. Second, as employee ownership of firms is not tradeable, the additional channel for error-correction by changes of ownership is blocked. It is on these two points that private and tradeable ownership of firms proves to have the decisive comparative advantage.

This clarifies, at least in the main lines, the decisive support that the competence argument provides for the proposition that private and tradeable ownership of firms is superior to both government and obligatory employee ownership.

To avoid misunderstanding, however, we must keep in mind that this proposition is about *institutionally defined forms of ownership*, and not about *individual firms*. Emphatically, not all government or employee owned firms are claimed to be inferior to their privately owned alternatives. The proposition only says that the entire

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[15]The high social value of this function lead some economists to advocate selective industrial policy as a means of ensuring that this function will be performed on a socially optimal scale. The spectacular failures of this kind of policy in practice clearly showed what the present argument claims in theory: public policy-makers are unlikely to have the exceptional competence required. As a consequence, they more often than not fail to recognize future winners, and instead waste valuable resources on temporarily bailing out future losers.

population of firms will evolve towards a socially more favorable state if ownership of firms is private and tradeable than if firms are owned by government or employees -- simply because the latter forms of ownership hinder or block important parts of EK-allocation. That the populations of firms may have tails where exceptions can be found -- such as efficient state-owned firms or efficient cooperatives -- is admitted, but with the important reminder that these are *and must remain to be* exceptions.

5 The speed and the sequencing of post-socialist privatization

What the previous section shows is that regardless of ideologies and political demands, there is a strong economic reason why ownership of firms should be private and tradeable. The question now is, what can be done, in terms of specific policies, to institutionalize a suitable form of such ownership in a post-socialist economy, where a very large number of firms are owned by the state. Let me divide this question into two parts: the one about the speed and the sequencing of privatization programs, to be discussed in this section, and the one about privatization methods, to be discussed in the following section.

To avoid confusion, policy analysis must clearly distinguish two phases of the privatization process. One is *privatization as institutional change* -- meaning legislation of a suitable framework of institutional rules within which private enterprise can successfully operate, such as property rights, business law, corporate law, antitrust law, and laws allowing capital markets to form and develop. The other stage is *privatization as structural change* -- meaning actual transfer of the existing government or employee owned firms into the hands of new private owners. Let me refer to these phases as R-privatization and S-privatization, respectively.

This distinction makes it possible to clearly realize the most important differences between post-socialist privatization and privatization in a Western-type mixed economy. In a Western economy, little, if anything, need be done in terms of R-privatization, as virtually all of the institutional rules required by private enterprise are already in place. In a post-socialist economy, in contrast, the framework of institutional rules must be built from the very beginning. And whereas in a Western economy, S-privatization may concern only a few state-owned firms and can substantially be helped by already developed capital markets, a post-socialist economy needs to find new owners for virtually all of its industry, while capital markets are seriously underdeveloped or entirely missing.[16]

The first observation is that R-privatization can and must be accomplished faster than S-privatization. The framework of suitable institutional rules is clearly a prerequisite for any meaningful transfer of specific firms to new owners. In principle, there are no economic constraints on the speed with which R-privatization can proceed. In the extreme, the formal institutional rules can be imported overnight, as was done in East Germany. In practice, however, R-privatization is not entirely without obstacles. What may confuse and slow down this process is that legislators may dislike importing foreign laws, while lacking the competence for choosing efficient institutional rules themselves. Moreover, formal legislation is not the only source of effective institutional rules, but many of them consist of culturally evolved informal norms (North, 1990). The problem is that after several decades of life in an inefficient socialist economy, accompanied by socialist indoctrination, many of the norms have evolved in the wrong direction -- e.g.,decreasing respect for property, unreliability in observation of contracts, and low working morale. As informal norms can hardly be changed overnight, but require a more or less lengthy process of social learning, effective R-privatization may thus be delayed.

This delay, however, is no reason for slowing down the legislation process and the efforts to have the new institutional rules respected. This should still be done as fast as possible. Moreover, policy can also help in accelerating the necessary social learning by investing in extensive educational campaigns, explaining principles of the working of markets and private enterprise to both the legislators and the citizens at large. The

[16]An interesting exposition of these differences is in Ferguson (1992). While Ferguson correctly argues that Western experience is largely irrelevant for post-socialist privatization, he cannot resist the temptation to use his own Western view for giving policy advice, which in the light of the present argument is absurd. His advice is to retain, "*at least* for the time being" (my emphasis), firms in state ownership and hire Western management teams for operating them, or for teaching the local managers to efficiently operate them. He completely ignores the enormous agency problem that such a solution would create, given the low competence and high propensity to corruption of the state administration by which the Western teams would have to be selected and monitored. Moreover, given the poor average performance of Western state-owned firms (see, e.g.,Vining and Boardman 1992) -- which is the main reason why they are now being so diligently privatized -- it is preposterous to suggest that efficient management of state-owned firms is something that the West can teach the East.

scarcity of economic educators, however, may be a serious binding constraint on this policy.[17]

In spite of these difficulties with R-privatization, it is S-privatization that is bound to take more time -- although again, this is no reason for slowing it down or postponing it. The reason is that it cannot avoid time-consuming steps, during which specific measures concerning each of the state-owned firm must be elaborated and implemented. The first step is relatively easy and hardly controversial -- it was indeed taken without much hesitation in most post-socialist economies. Often denoted as 'commercialization', it consists of transforming all such firms into independent commercial units. This involves cutting off their automatic connection to the state budget, and thus making any further subsidies a matter of case-to-case policy decisions.

The best policy -- which however only a few post-socialist economies had the economic wisdom and the political courage to adopt -- is a rapid phasing out of all further industrial subsidies. A prerequisite for this policy is -- and this implies another timing constraint on S-privatization -- liberalization of prices, convertibility of currency, opening of access to foreign markets for both imports and exports, and also readiness to admit bankruptcies.

A comment on the usual objections to this policy is useful. They are the natural instruments of the incumbent 'nomenclatura', whose vested interests the policy seriously threatens. As some of them cannot be refuted without a certain minimum of economic competence, which is not always available, they may be listened to and cause high social losses by slowing down or even interrupting the entire transformation process, while the economy continues to deteriorate.[18] Two objections appear particularly difficult to refute: (i) the objection to price liberalization which points out that even promising firms cannot rapidly adapt to an entirely different price structures of their inputs and outputs; and (ii) the objection to the phasing out of industrial subsidies which points out

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[17]It seems that much of the relative success of the Czech transformation process is due to such campaigns. While the actually taken policy measures were about the same as in many other post-socialist economies, the effort spent on explaining how markets work and why the measures were taken was unique. This, I believe, is an important factor which allowed the relatively radical Czech transformation policies to obtain and maintain broad political support, without any serious relapse into old socialist illusions.

[18]Ukraine is perhaps the most spectacular example of rapidly worsening economic situation due to *absence* of radical reforms. Why radical reforms certainly have their social costs and difficulties, Ukraine clearly shows that the costs and difficulties caused by their absence are substantially higher.

the high social and individual costs of the unemployment that would be caused by closing down all those firms that cannot become rapidly profitable. That these objections serve above all the vested interests of the 'nomenclatura' should be emphasized:[19] the artificially low prices of energy and raw materials, which objection (i) tries to maintain, are sources of enormous rents for all those administrators that can arrange for some private exports at world prices; the industrial subsidies that objection (ii) tries to maintain in the name of the employees of wasteful firms help above all the incumbent and often inadequately competent managers of those firms. Without entering into detail, let me just point out the most important principles of the answers. Concerning (i), firms can be given time to adapt to efficient prices without delaying price liberalization. The principle to follow is a (temporary) transfer of the subsidies hidden in inefficient prices of inputs to open subsidies to the consumers of these inputs.[20] This leaves both these consumers and the state finances initially in the same static position, but gives the consumers -- and this is the crucial difference -- a strong incentive to start economizing on these inputs. Concerning (ii), the principle to follow is that after a strictly limited period of decreasingly subsidized opportunities for efficient restructuring, the only efficient way for softening the negative social impact of radical transformation policies is helping persons -- both materially and educationally -- but not loss-making firms. Each day during which such a firm is prevented from wasting valuable inputs on the production of less valuable and sometimes entirely useless outputs is a net saving to society.

Note that this principle is true even in the borderline cases, in which the sum of personal subsidies to the employees is larger that the sum of the required subsidies to the firm. In such cases, the productivity of the firm is positive if labor is cheap, and subsidizing it may thus appear superior to closing it down and subsidizing unemployment. Yet, subsidies should still go to persons, and not to the firm, but must be formed in such a way that they do not discourage low-paid employment. This allows such a firm to survive by attracting labor even at low wages, but only as long as better paid jobs do not

[19]Some Western theoretical economists contribute to supporting these objections by their simplified theories, apparently without seeing these interests.

[20]A variant of this principle was successfully applied in the former Czechoslovakia for taking away subsidies for food without making life too hard for local consumers.

appear. To subsidize the firm would result in wasting the labor by locking it to such poor uses, and thus preventing creation of superior alternatives.

Let me now return to the first step of S-privatization, for which price liberalization and phasing out of industrial subsidies were shown to be prerequisites. Another prerequisite is establishment of a government agency which assumes the role of the formal owner of the commercialized firms. What is not always well seen, but the competence argument makes clear, is that because of its origins in politico-administrative rather than market selection, this agency is unlikely to be a highly competent owner. It should indeed be emphasized that democracy is no panacea: the change of the political system from one-party dictatorship to democracy -- however valuable this change might otherwise be -- does not increase in any substantial way the expected economic competence of politically selected agents. In consequence, this agency should not do much more than be the formal counterpart to the new owners -- when these are found -- in the transactions of the ownership titles over the privatized firms.

In particular, it would be unwise to entrust it with the highly difficult task of industrial restructuring -- with the exception of cutting the oversized government firms into smaller units, for which interested new owners would be easier to find. It should definitely avoid all sophisticated, competence-demanding restructuring and all selective industrial policy trying to recognize, select, and support future winners. As noted, because of insufficiency of relevant competence and integrity of public policy-makers, such policy caused enormous social losses in the developed West, and must therefore be expected to cause even higher losses in a post-socialist economy, where this competence and integrity are likely even lower.

The competence and integrity constraints on public policy-making constitute a powerful reason why the bulk of industrial restructuring should be left to the new owners. In other words -- and this is the main implications of the competence argument for the sequencing problem -- *privatization should precede restructuring*.

Note that this fully agrees with the opponents to privatization that the objective proper is efficient industrial restructuring, which would replace backward industries full of mismanaged firms by modern industries populated by elite firms, and not privatization as such. It is only shown that privatization is a necessary instrument for such restructuring.

At this point it is useful to recall an important lesson of evolutionary economics -- which both Western economic experts, fluent in static analysis of already developed market economies, and Eastern planners, used to think that all economic changes must be ordered from above, often fail to see. The starting point is the finding that -- because of imperfect information and scarce competence -- no efficient industrial restructuring can do without experimental trial-and-error processes, which Schumpeter (1942) so beautifully called 'creative destruction' (Pelikan 1987, Eliasson 1988). In other words, the restructuring cannot do without closing down many of the existing plants and entire firms and making room for tentative entries of new firms, not all of which can be expected to succeed. The lesson can be summarized as follows. Only a miracle could keep the 'destruction' in a perfect balance with the 'creation': this would indeed require that all the employees of the old closing firms would immediately be re-employed in some 'just-in-time' opened new firms of precisely the same total size. In the real world, where miracles do not happen, the destruction can and must go ahead of the creation. Although this results in unpleasant 'destruction-creation gaps' with temporary growth of unemployment, any policy trying to avoid such gaps by hindering the destruction is unwise. Namely, any slowing down of the destruction by subsidizing the declining firms binds scarce resources to inefficient uses, and thus inevitably also slows down the creation. This delays the structural recovery, destroys macroeconomic stability and currency, and substantially increases the cumulative social costs of the entire transformation.[21] The above-mentioned subsidizing of unemployed persons, but not declining firms, is the only efficient policy by which the negative social effects of the destruction-creation gaps can be alleviated. Creating favorable environment to entrepreneurship -- that is, clearly defining hospitable institutional rules, preventing predation by incumbent state-owned enterprises, opening access to international markets, and providing for organization of capital markets -- is the only efficient policy by which public policy-makers can help the gaps to narrow.

The second step of S-privatization is more difficult and time-consuming than the first one. It consists of finding the new owners for each of the privatized firms and transferring to them the effective control over these firms. What makes this step so

[21]Ukraine can again be referred to as a particularly frightening example.

difficult and time-consuming is usually a combination of several unfavorable factors -- in particular the great number of the firms to be privatized, the poor shape of most of them, the lack of capital and competence for improving this shape and, in some of the post-socialist economies, the lack of interest among the population for assuming the risks and the responsibilities connected with the ownership role.

None of these difficulties, however, is a good reason for *purposefully* slowing down, or renouncing to, the privatization of state-owned enterprises. Given the competence and integrity constraints on government administration, which are typically much more severe in a post-socialist economy than in a developed West economy, to retain these enterprises in state ownership is not a reasonable option -- contrary to what some Western economists believe (see, e.g., Ferguson 1992). What the above argument emphasizes is that privatization is not a mere political objective, that can be diluted or traded off for other political objectives, but a strict economic necessity, without which industry cannot be efficiently restructured, capital markets cannot develop, and the entire transformation process must fail (see also Grosfeld 1992, and Pelikan 1992).

It may be useful to repeat that China, whose main problem is *development* and where state-owned enterprises are far from controlling all available resources, is not a relevant example for the highly but wrongly developed post-socialist economies in Europe, whose main problem is *restructuring* and where the private sector cannot properly grow without first dismantling the state sector (cf. footnote 2 above). This argument is strengthened by the (in the West) rarely noted fact that the state-owned firms in these economies, besides locking most of the available resources to inefficient uses, have moreover often engaged in predatory behavior vis-a-vis the emerging private sector -- e.g., by refusing to supply inputs, or to pay for outputs.

Given the high priority of post-socialist privatization -- at least in the more developed post-socialist economies in Europe -- the only hopeful strategy for coping with its extraordinary difficulties is to choose an extraordinary privatization method which could cope with them at lower social costs than the high costs of retaining firms in state ownership.

7 The choice of the privatization method

It is above all for S-privatization -- the actual finding of new owners and transferring to them the effective control over the privatized firms -- that the choice of method poses a problem. Different methods differ in their maximum speed and in their impact on efficiency and equity, especially in the short run. In the long run, of course, if the relevant institutional rules are suitably designed and the capital markets are allowed to do their job, the most serious inefficiencies of the initial distribution of control over firms will be corrected. But this does not mean that short-run effects should be underestimated. They may have important political consequences, on which the entire transformation process may substantially depend. Hence not all privatization methods are equally suitable. For example, a particularly unsuitable method, widespread in some post-socialist economies, is stealing of state-owned firms by incumbent managers (sometimes euphemistically called 'spontaneous privatization'), for both its economic and political consequences are strongly negative. The question therefore is, which methods are more suitable than others.

Ideally, the new owners should meet two conditions: (1) they should have enough financial capital available, both to pay a high price for the firm, in order to make a large contribution to the strained state budget, and to invest in the firm itself, in order to modernize its obsolete equipment; (2) they should have high relevant competence, in order to provide -- directly, or by means of competently appointed and monitored intermediaries -- for efficient reorganization and high quality management. The problem is, what is to be done in a post-socialist economy, where candidates meeting both these conditions are in an extremely short supply, even when potential foreign investors are included, given the very large number of the firms to be privatized.

This problem is rarely seen in its full extent. In standard analysis, as noted earlier, the scarcity of economic competence is assumed away, which means that only the first condition is considered. For many Western economists, the privatization problem is indeed reduced to the problem of financing. In consequence, their policy advice is to insist that only those candidates who can fully meet the first condition be eligible. That this is not a very good advice is now clearly documented by the experience of Hungary and the former East Germany, where it has been followed. Hungary, which was first to start with post-socialist privatization, is now lagging in the proportion of privatized firms far behind the Czech Republic and Russia, which started to privatize much later. In the former East Germany, the privatization could proceed only thanks to a large number of

West German investors, with social and political consequences reminding of colonization: very few East Germans could enter the competition for the control of firms which formally belonged to them.

Without underestimating the problem of financing, the present argument is that it is the need to find high relevant competence that is primary. The problem of financing is seen secondary simply because with low competence, all financial resources are mostly wasted, whereas with high competence new financial resources are likely to be discovered and attracted.

To be sure, candidates meeting both the above conditions should not be neglected. But when they are in short supply, compared to the large number of firms to be privatized, the main role of privatization should be seen in searching for new owners of high relevant competence, able to improve upon the inefficient organization and poor management of most of the state-owned firms, with only a limited attention paid to their initial capital strength.

That this must be a search process which cannot avoid trials and errors should be emphasized. Indeed, after several decades of non-market selection for top economic jobs, the relevant high competence (or the scarce talents for learning it) can now be dispersed over the most unexpected places, on which prior information is nearly impossible to obtain. Moreover, recalling that high economic competence is needed for recognizing high economic competence, no government privatization agency can be expected to have very good criteria for telling true relevant competence from mediocrity, often hidden behind impressive formulations.

As argued earlier, the relatively best method for conducting such a search is selection by developed capital markets. In any post-socialist economy, however, a well-known difficulty is precisely that such markets are there underdeveloped, if they exist at all.

What I now wish to argue is that there *is* an extraordinary privatization method that copes reasonably well with most of the extraordinary difficulties of post-socialist privatization. This is the privatization by (nearly) freely distributed investment vouchers, to be used in auctions for shares in firms. The method is of course not new, for it has already been employed in several post-socialist economies -- such as the Czech Republic, Estonia, and Russia -- and has for a long time been discussed in Poland. But it has been difficult to show its correctness: it has been rejected by virtually all Western theoretical economists, and avoided by many other post-socialist economies -- such as Hungary and East Germany. My argument is only to show that there is a sound theoretical reason which can support it, and moreover specify some of its more detailed properties.

The reason directly stems from the competence argument. Emphasizing the importance of the search for relevant competence, this argument appreciates voucher privatization above all as a first step towards an efficient EK-allocation. This is indeed the most effective way of starting an open tournament, able to select future champions of industrial organization and management -- whom no one can know in advance -- from the largest number of initial candidates.

Among the more detailed properties, two turn out to be of particular importance. First, the method must allow for free entry of investment funds, to allow individuals who prefer to be passive owners to choose their delegates, and those who on the contrary wish to be active owners to start funds of their own and try to become such delegates. Second, it must allow for immediate secondary trade with the acquired shares. It may appear advantageous to allow for secondary trading already with the vouchers, as has been possible in Russia but not in the Czech Republic. But, given the above-mentioned importance of economic education, forcing all citizens to be responsible for the use of their vouchers at least until the choice of a suitable investment fund turns out to have a non-negligible pedagogical value. Namely, this forces them to learn about the state and the prospects of different firms and/or investment funds, and the learning may have positive spillover effects on the future working of both market economy and political democracy.

As objections against secondary trade are frequent, even among the advocates of voucher privatization, an additional note may be useful. The usual argument against it is egalitarian, demanding that ownership of capital be and remain equitably distributed. This is to be achieved by preventing less competent owners from selling their vouchers or shares "too cheaply" to the more competent ones. Clearly, this is the very opposite of what the competence argument shows should happen. To be sure, broad continuing involvement of small shareholders has many positive social, educational, and political effects. But the main purpose of the entire voucher privatization is precisely to find as rapidly as possible a few strong competent owners, able to lead the necessary industrial restructuring, for which neither government officials nor the incumbent managers can be expected to have sufficient competence (some of them may well have this competence, but it is initially not known which ones!). While policies limiting economic inequalities need not be entirely abandoned -- as is mentioned below and shown in Pelikan (1993), the competence argument is more hospitable to them than the traditional incentive argument -- their impact must be limited to final consumption, without disturbing the allocation of economic competence in the organization and management of production.

Two objections against the very principle of investment vouchers are also instructive to consider. One is due to Kornai (1990), who is preoccupied with the financing problem and objects against free distribution of state property on moral grounds. For the state firms that cannot be sold at a market price he prefers continued state ownership, which he justifies by the optimistic belief that the state administration is in good health and can guarantee efficient management. This objection can be refuted on at least two points. First, the state property is formerly the property of all citizens. Investment vouchers thus give nothing away for free, but only partition an already existing ownership relationship into small tradeable pieces, with which the market search for competent owners can begin. If moral grounds are to enter the argument, I believe them on the contrary weaker in the case of a state bureaucracy selling out the state-owned firms, while often cashing in personal rents, behind the back of the population at large. Second -- as follows from Section 5 above -- Kornai's belief in state administration as a guarantor of efficient management of firms is grossly over-optimistic.

The second objection is due to Corbett and Mayer (1992), who claim that industrial restructuring in a post-socialist economy should rely on large investment banks, and not on competitive capital markets, quoting Japan and Germany as the models to imitate. What this claim forgets is that also competent investment banks are scarce creatures which are not easy to obtain, and especially not in a newly liberalized post-socialist economy. Of course, that such banks would be of much help cannot be denied. What the present argument points out is that without competitive capital markets, competent banks are unlikely to emerge and remain competent.

That the present support to voucher privatization does not include all of its methods should also be noted. For example, what is not included is the method that was about to be adopted in Poland, which allows only a restricted number of government appointed investment funds to bid for shares of firms, whereas individuals are given vouchers only for shares in these funds. This strongly restricts the competition for the ownership roles; moreover, the fact that the allowed competitors are selected by government administration is a further handicap, likely to favor mediocrity and exclude many true but yet unknown talents. In the short run, to be sure, this method may be more successful than the one which allows for free entry of investment funds -- such as in the Czech Republic. The reason is that it guarantees a certain minimum professional standard right from the beginning, whereas the Czechs are likely to commit more errors, including bankruptcies of many of the spontaneously emerged investment funds. In the long run, however, the Czech method is predicted to select more of true industrial champions, and thus result in a more advanced industrial structure.

7 Concluding comments

In a post-socialist economy, after several decades of inefficient economic practice and confusing socialist indoctrination, economic competence is an extremely scarce and grossly misallocated resource. As pointed out, the problem of its scarcity and efficient allocation is there substantially more serious than in a developed capitalist economy, where market selection -- although often unnoticed by economic theory -- has been at work for a long time. And even if this selection has sometimes failed to promote the most competent agents, it has done an invaluable job in demoting the inadequately competent ones.

The main strategy of this paper has been to make the competence problem the central point in the study of post-socialist privatization. The result is a stronger support for this privatization than the one provided by the usual incentive argument. The incentive argument is indeed weakened by all findings that suggest that human beings may be more altruistic creatures than what economists usually assume. Moreover, it is also weakened by the fact -- demonstrated by both economic theory and managerial practice -- that reasonably efficient incentives can often be designed even for non-owners. None of this, in contrast, weakens the present argument based on scarce economic competence. If economic agents are unequally imperfect optimizers and no one initially knows how imperfect different agents, oneself included, are, then even an ideal team in the sense of Marschak and Radner (1972) -- whose members need no individual incentives to pursue its objectives -- must solve the intricate problem of how to allocate the most important decision tasks to the a priori unknown least imperfect optimizers. It is as a means of solving this problem that private and tradeable ownership of capital and competitive capital markets turn out to be irreplaceable, even within such a perfectly altruistic team. There, of course, capital holdings only determine the decision authority of their owners in organizing production, as opposed to a real economy, where they moreover determine the opportunities for personal consumption. However, regardless of what redistributive policies might be considered for final consumption, the decisive point is that more competent industrial leaders will likely be appointed by means of private and tradeable ownership of capital than by ministerial decrees or one-person-one-vote elections.

A qualification, however, should be added. If capital markets are to realize their potential in selecting for high relevant competence, they need to be protected by both written and unwritten institutional rules against distortion by other selection criteria -- such as ruthlessness or dishonesty. The ways of becoming rich are thus exposed to be a matter of public concern, for which social efficiency requires maximum transparency, similar to what is required for the ways of acceding to public functions.

If the nirvana fallacy is to be avoided, however, this qualification in turn needs to be qualified. Failures in the protection of capital markets must not be judged absolutely, but only in comparison with what protection against ruthlessness and dishonesty can be provided for the selection of politicians and government officials. Casual observations suggest that where it is difficult to secure honesty in business, it is usually not less difficult to secure honesty in politics and government administration. In such cases, government ownership may still not be the socially superior alternative, however distorted the selection by capital markets might be.

In addition to providing a strong support to post-socialist privatization as such, the competence argument also made it possible to throw new light on several controversial questions about the speed, the sequencing, and the method of such privatization. In particular, it is shown that privatization should proceed as rapidly as possible; that it requires liberalization of prices, convertibility of currency, opening of access to foreign markets for both imports and exports, and readiness to admit bankruptcies; and that it is itself a prerequisite for efficient industrial restructuring. The competence argument moreover supports methods of privatization which use (nearly) freely distributed investment vouchers in public auctions, provided that free entry of investment funds and immediate secondary trade are admitted. As the main purpose of privatization is found to be the search for and selection of scarce competent owners, the crucial advantage of these voucher methods is that they allow for open competition in which such owners can be selected from the largest number of initial candidates.

Finally, let me briefly mention why the competence argument is more hospitable than the traditional incentive argument to egalitarian values. The main reason is that scarce competence, or exceptional talents for learning it, may also appear where money is not: some highly talented agents may simply be so poor and mistrusted that they cannot mobilize the minimum starting capital to enter the competition for ownership of firms, which causes their scarce talents to be socially wasted. In an extreme case, this competition may even become limited to a small closed group where the best talents can no longer be found, while self-perpetuating poverty would excludes the rest of the population. Hence mild redistribution that maintains access of scarce competence and talents to starting capital (including human capital by means of education) may more than countervail its negative effects on incentives. A warning, however, should be added. The negative effect on incentives, including the very incentives for acquiring competence, should not be forgotten. It is these effects that would prevail if redistribution became too ambitious. Efficient egalitarian policy must therefore be limited to mild redistribution, for which the positive effects on broadening the field of competition for ownership still prevail over the negative effects on incentives.

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