

# Pareto-Optimal Privatization for Gaining Political Support

By George M. von Furstenberg\*, Bloomington/Indiana

That system which evolved over decades was really a kind of vice, was really a kind of cramp on our entire economy, and it made impossible any initiative, any decision-making at various levels, and therefore we had to try and dismantle that command system ... [W]e see that if that process takes too much time, it can create the kind of instability and the kind of implications that will disorganize our entire society.

*Mikhail Gorbachev speaking to Congressional leaders  
at the Soviet embassy in Washington, June 1, 1990.*

## I. Introduction

Privatization with a grant component could well become highly attractive politically once ideological barriers have fallen. Then the main problem might be how to restrain popular demands for immediate privatization on concessional terms. In reality, however, no such restraint has proved necessary, and privatization has been more curse than blessing for politicians. It

---

\* The author, who is Rudy Professor of Economics at Indiana University, was a Visiting Senior Economist with the U.S. Department of State's Planning and Economic Analysis Staff when this paper was written. There his work on privatization and Eastern Europe was stimulated and encouraged particularly by *Eugene J. McAllister*, *William G. Dewald*, and, most immediately, by prior work by and with *Richard English*. He also acknowledges the many useful comments received in the panel discussion on "Privatizing Socialist Economies" conducted on June 30, 1990 in San Diego at a session of the Western Economic Association organized by Dewald and chaired by *Gordon Tullock*. Comments by *Michael Ulan* of the U.S. Department of State also have helped improve earlier drafts, but the State Department and the U.S. Government are not responsible for the views expressed. The author has benefitted from conversations with *Peter F. Schaefer* of the Agency for International Development, *Alan Gelb*, *John Nellis*, and *Fernando Saldanha* of the World Bank, and *Edward A. Nassim* of the International Finance Corporation, as well as from the brown-bag Seminars on Privatization, organized by Dewald at the State Department. To these and to other persons, whose work is mentioned in the references, he wishes to express his sincere thanks without holding them responsible for any errors remaining in this work. Author's address: Department of Economics, Indiana University, Bloomington, IN, 47405, USA; Phone: (812) 855-4764, FAX: (812) 855-5678.

has been assailed in a number of countries and met with widespread resistance in spite of mounting evidence of the failure of government as producer and director of economic development. Because it has proved hard to make privatizations proceed on a large scale, political obstacles to the process will be considered in this paper together with its economic promise.

## II. Recent Approaches to Privatization in East and West

There are powerful stakeholders in the system of socialized industry who – as subsidized customers, privileged workers, sheltered managers, or political patrons – favor the maintenance of the *status quo*. To characterize the situation, not only in Central Europe, Kornai (1990b, p. 141), for instance, has offered the understatement that “neither the bureaucrats, nor the managers, nor indeed the workers [are] enthusiastic adherents of competition or of the marketization of state-owned assets.” Not surprisingly, therefore, in some countries, like Argentina, it has proved difficult to make privatizations stick. In others, like in Hungary and Turkey, the process has been interrupted and redirected repeatedly, as yet preventing any pervasive transformation.

Even where privatization has been relatively far-reaching, clean, and swift, like in Chile, it has not been viewed as an unqualified success (see Nankani, 1988, pp. 17 - 45; Yotopoulos, 1989). Particularly in countries whose capital markets are barely developed, privatizations frequently have been discredited by rewarding insider groups. From A to Z, Algeria to Zambia, countries have found it a daunting task to make privatization a popular cause and to avoid political recriminations. There are, of course, a few exceptional cases, such as the United Kingdom and New Zealand, in which privatization has proceeded steadily with broad political support during the past decade. Generally, however, while socialization has often been precipitate and radical, privatization has been hesitant and partial.

The purpose of this paper is to establish and apply standards that would move the process along by making it preferred, by almost all the residents of a country, to staying put. Privatization and demonopolization of the bulk of socialist industry are necessary for the development of efficient markets and high-quality products. As in Hemming and Mansoor (1988), the only form of privatization considered here involves the transfer of ownership of public enterprises to the private sector and not such other modalities as the contracting-out of public services to private firms. Starting from socialist economy, this transfer of ownership is a precondition for depoliticizing, deregulating, and demonopolizing economic decision-making. It involves open-

ing up to the world market to let firms discover and seize technological and trade opportunities without the state's rigging. Although privatization does not, by itself, guarantee any of these economic benefits as Yarrow (1989) has shown for the United Kingdom, it makes efficiency gains highly likely, thereby giving it a wealth-creating effect.

*De Soto* (1989) has given a stunning demonstration that freedom of entry and legal security – protected through low-cost licensing and the granting of clear ownership titles together with equal access to offices and courts and impartial and effective law enforcement – must accompany the institution of property rights to make activities relying on such rights universally available and socially productive. Property rights must confer substantial freedom of disposition and establish private responsibility for the consequences of exercising that freedom in terms of profit or loss. Hence the substance of these rights is inversely related to the degree of regulation, “social” imposition and prohibition, and capital and capital-income taxation. Yet while the content of property rights is not guaranteed by having formal title, privatization remains the essential condition necessary for greater efficiency and development. As the *Blue Ribbon Commission* (1990, pp. 21 - 22) has pointed out, there are good reasons to expect private enterprise, subject to competition and the rule of law, to improve productive, allocative, and innovative efficiency.

### 1. *Speed is Essential for Success*

There are at least two dangers associated with moving slowly or just waiting patiently under “bypass” strategies for the public sector to be eclipsed by the emergence of a private sector and its internal growth. First the clout and blocking powers wielded by the government through control of its enterprises and the political network that supports them remain formidable and discourage private entry. Second, even after the disciplines and rituals of command economy have been abandoned, government enterprises still operate at social risk and cost, rather than at profit and loss, until they are privatized. The rewards of managers thus continue to be filtered through the political rather than economic process and are not directed toward enhancing the efficiency of current or future operations. Instead, connivance by insiders and political appointees may gut the substance of government enterprises. Leaving socialist industry in limbo thus does not seem to be wise. Rather, both old and new managements of government enterprises should be energized by the certain prospect of privatization and compete for a place in the new order as they did in the United Kingdom once their mandate and authority had been firmly established (*Walters*, 1989, pp. 197 - 199).



Conditions and concerns that may apply to industrial privatizations at the fringes of highly-developed market economies need not be appropriate for the privatization of socialist economies. Yarrow (1990, pp. 19 - 21) recognizes this difference when he advises tipping the balance of the arguments toward faster privatization in Eastern Europe although he had questioned “preoccupation with ensuring a rapid transfer of ownership” (1989, p. 343) earlier in Britain. Hinds (1990b, pp. 4 - 5) also comments on the difference between privatization in the United Kingdom and in Central Europe and puts a premium on speed for the latter. Lindbeck (1990, p. 3) argues that large-scale privatization and supporting reforms have to “move *fast and without hesitation* so that private property rights become credible. Only then can a proper incentive structure for private ownership be created, with confidence in the private sector about future property rights and favorable working conditions for private firms” (emphasis in original).

Apparently favoring a much more gradual approach, Kornai (1990a) has advised Eastern and Central European countries to be prepared for “a lengthy period of coexistence” (p. 101) during which “the tiny isles of the private sector are surrounded by an ocean of state-owned firms” (p. 59). He further cautions that “the sale of state property should *not* be governed by the guiding principle of speed” (p. 93) and that state property should change hands only “at a real market price” (p. 83).

This paper, by contrast, deals with the possibilities for creating a political dynamic that helps push government enterprises onto the market and lets restructuring proceed without waiting for definitive revelation of the “real market price” to be charged for their assets. For state agencies to spend much time on precise valuation and then to hold out for a price equal to appraised value may be a losing proposition: The value of socialist enterprises is likely to dissipate rapidly in factor and product markets that have opened-up to the world.

To be able to privatize quickly, however, any government that depends on the consent of the governed needs political cover. This paper, therefore, tries to set up some standards (section III) that a program should meet to garner the broad-based political support necessary for rapid privatization. It also shows how these standards apply in privatizing publicly-owned housing of fairly certain value (section IV) and socialist industry of uncertain value (section V) before concluding this study in political economy (section VI).

The conviction underlying much of the discussion that follows is that when the basic economic structures of a society have become discredited and living standards have plummeted, efficiency-enhancing measures can



gain broad political support. Indeed, mobilizing the general interest against the insiders of the dilapidating regime may be a precondition for discovering economic opportunities and getting onto a path of efficient development. In this way, greater political and economic equality can be the engines of transition to a more efficient regime: equality and efficiency need not be “the big tradeoff” (Okun, 1975; see also Barr, 1987, and Winfield, 1988) they normally pose in established regimes. The remainder of this introduction touches on the social ethics involved in mobilizing broad political support for privatization and explains the concept of concessional privatization and where it has been used.

## 2. Social Ethics and Politics

The debacle of socialist economy has shown first of all that rigorous pursuit of egalitarianism shrinks the cake available for distribution. Furthermore, a pursuit without individual rewards can be sustained only with commands from above. This hierarchical element ultimately denies egalitarianism itself: Some find ways to escape from the general impoverishment by turning a profit from political clout. Hence, neither acceptable living standards nor equality in misery can be rescued from increasingly costly coordination failures and “spontaneous privatizations” in economies without well-functioning markets. Rather, the denial of property rights and personal autonomy, ostensibly in the name of equality, eventually leads to a point where the appearance of equality too is undermined. “Nomenklatura” privileges become openly resented, rupturing acquiescence and breeding unrest. In the end, therefore, both equality and efficiency suffer.

More importantly, basic human needs, including the essential dignity of having room for individual choice and creation, dear to the original Marxian conception of the final rewards of communism, increasingly fail to be met. For this reason Myrdal (1989, p. 16) concluded in his 1975 Nobel Memorial Lecture that the fundamental changes in working conditions that can overcome state-centered underdevelopment „regularly imply both greater equality and increased productivity at the same time.“

Even if equality and efficiency did not change in the same direction under the popular privatizations to be discussed in sections III and IV, there would be ample room for raising efficiency while still improving the lot of the least well-off. Only a beneficial effect for the poorest would provide the moral justification which Rawls (1971) required for any disequalizing change. With safety nets hanging low and ragged in what once prided itself as the

socialist camp of Europe, one can see that even the least well-off are less wretched and have more hope of improvement in developed market economies, by and large. Thus any disequalizing changes could be so productive for all, including the poorest, as to pass the Rawls criterion. Indeed, politically, it is quite essential for the security of the democracies now emerging in Eastern Europe that the poor, the mass of the population, get a stake in the process of privatization and agree with the broad outlines of its design.

### 3. *Recent Proposals of Concessional Privatization*

Mass participation and support can be sought through concessional privatization. It involves charging less than the presumed or already going market price for claims to government assets that are widely or universally distributed. It can also involve using part of the proceeds from "full-price" sales to small groups of active investors for transfers to the general population under the egalitarian scheme. Alternatively, full-price sales to active investors of controlling interests in formerly government-owned enterprises can be combined with making the remaining equity available for acquisition through share stamps (analogous to food stamps) or vouchers redeemed in stocks by the population at large.

Concessional privatization, in one form or another, has numerous advocates and antecedents. Its extreme, frequently advocated but rarely practiced, is the government-asset giveaway, a term popularized by *Brittan* (1983). Spurred by events in Central Europe, there has been a resurgence of editorial recommendations of this type of approach in the region (see *Grosfeld*, 1990, p. 145; *Bobinski* and *Wolf*, 1990; *Dyba*, *Jezek* and *Arbess*, 1990) and in Western Europe. Because of the rapidity of the events that began to unfold in summer of 1989, business, economic, and financial newspapers have become the main forum of serious debate.

The last of the Western European endorsements noted here appeared in the *Economist* of July 21, 1990 (pp. 13 - 14) under the title, "The Gift of Capitalism." Editorials earlier that year repeated the basic ideas first advanced by *Brittan* (1983, 1984a, 1984b) for the United Kingdom and applied them to Eastern and Central European countries, including the Soviet Union (*Feige*, 1990b; *Moore*, 1990) and the now extinct GDR (*Bofinger*, 1990; *von Furstenberg*, 1990). *Ohashi* (1987) and *Stolper* (1990) have provided useful surveys of earlier, small-scale applications in British Columbia and in the dissolution of the Amana Society in Iowa. *Stolper* (1990, p. 18) notes that "a wide distribution of diversified assets would sup-

port democracy by greatly reducing the economic power of the *nomenclatura* and greatly increasing the economic power of the electorate.” *Vanous* (1989), *Svejnar* (1989), and *Crane* (1990) have also addressed the question of how to build political support for privatization, a question that is central to this paper and the entire process.

### III. Political Safety Standards for Privatization

In a technical and political sense, privatization is much easier to arrange for public housing than for the assets of socialist industry. Detailing the terms available for privatization in each of these areas provides an insightful contrast. As justified later in this section, the three principles advocated in varying degrees for minimizing political risks to privatization in both areas are:

(1) The Treasury shall not suffer any net loss of fiscal resources as a result of privatization lest some citizens lose from the process as future taxpayers or victims of inflation tax.

(2) Those with politically-legitimate ownership claims in the assets to be privatized shall be held harmless for loss of the economic rents which these assets would have continued to deliver to them directly under the old regime.

(3) Any proceeds from privatization beyond those needed to satisfy the two constraints above shall be distributed broadly, perhaps to the entire population of voting age, to maximize political support for the program of rapid ownership transformation.

Each of the three principles or distributional guidelines and constraints needs to be justified.

#### 1. Fiscal Indemnification

The amount of revenue which the government should retain from the sale of socialist industry can be gauged only by preparing a detailed budget extending over a number of years. During those years, a tax system would be put in place that could support a greatly reduced level of government spending without further variation in tax rates. Even though concrete application of principles of tax efficiency and intertemporal tax equity is difficult, it may be worthwhile to lay out the major points that need to be considered in setting the level of the fiscal indemnity.



First of all, why should people be asked to pay the government anything at all for returning “their” collectively-owned property? Certainly in the initial transfer of government-enterprise assets and liabilities to the private sector, that sector as a whole should not have to put up “full price” for the package if other equitable formulae for divestiture can be found. Otherwise privatization would be prevented from making an immediate contribution to the restoration of private net worth that was gutted by decades of socialism. Of course, active investors who acquire direct ownership of government enterprises should always have to pay “at market” for what these enterprises are expected to be worth as going concerns. However, all that these direct investors pay need not be retained by government; it can be redistributed, in part, to the population at large. Buying a resalable asset at below-market prices is equivalent to receiving a gift equal to the discount from market. Hence bestowing such a gift through payment of a “social dividend” is equivalent to letting everyone participate in the privatization on concessional terms, even though few will end up owning and managing the privatized assets.

On the other hand, not all the proceeds from privatization should be made available for payout in this way. Indeed popular demands for capital grants from the state are subordinate to the goals of maintaining fiscal stability and protecting future taxpayers from increased liabilities on a present-value basis. People thus can be asked to redeem enterprises from government ownership for an amount sufficient to avoid destabilizing government finances. This amount could be equal to any excess of the taxes and dividends that would have accrued to the state from continued ownership over the tax revenues that government enterprises would be expected to pay upon privatization when taxes are designed optimally over time. Hence any loss of future net revenues associated with privatization, calculated on a present-value basis, might have to be made up by the proceeds obtained from the sale of government assets.

How might one gauge the loss of net revenue, and why is it likely to be small compared with the gross receipts from government enterprises usually entered in the fiscal accounts of socialist countries? Such receipts have been a major source of government revenue in Eastern Europe, yet a good part of them was recycled in a closed loop. An example taken from Poland may show what could be involved. In 1988, before the fiscal situation had as yet become unsustainable there, tax revenue from the socialized sector amounted to 31 % of GNP. Subtracting most of the subsidies to the population (80 % of such subsidies are assumed to be on products made by government enterprises) and all of the enterprise subsidies (the latter amounted to

6 % of GNP) leaves net receipts equal to 31 % - 14 %, or 17 % of GNP. But turnover (11 % of GNP) and wage taxes (4 % of GNP) withheld by socialist enterprises are included in the last figure. These taxes could yield just as much under private ownership, or 15 % of GNP. Hence any net loss of fiscal revenue from privatization and the removal of subsidies may be equal not to 17 % but only to 2 % of GNP. Capitalizing this infinite stream at a real interest rate of 4 % yields 50 % of GNP as the sum required for compensating the fisc. Since efficient capital/output ratios are generally no less than 2 (for the Soviet Union, see *Feige*, 1990a, p. 18), fiscal indemnification should thus require at most one-quarter of the replacement value of the capital assets of government enterprises.

While one quarter of the market value of government assets may easily be enough to indemnify the fisc for the net fiscal losses from privatization deduced so far, there may be additional losses. First of all, government enterprises may have to be sold with substantial amounts of the existing debts still attached, thereby raising the effective selling price. In some cases it will not even be feasible to arrange a sale that would convey all the debts outstanding against a particular government enterprise to the successor corporation. In preparing for privatization not only of the nonfinancial but also of the financial system, the foreign and domestic debts and arrears of non-financial government enterprises that are unassumable privately will therefore have to be taken over by the central government (see *Brainard*, 1990; and *Blue Ribbon Commission*, 1990, pp. 47 - 50 for extended discussions). To the extent they are, the proceeds from privatization of the most profitable and least indebted enterprises may have to be attached to protect future taxpayers from increased claims.

By privatizing the state banking system and freeing interest rates and capital flows, the government will create the preconditions for an efficient allocation of credit throughout the economy. At the same time it will greatly limit its ability to tax its citizens through inflation. Spoiling this tax base and thereby discouraging inflation may well be a benefit rather than a cost of privatization, particularly since inflation tends to reduce tax equity and the real value of explicit taxes. Even so, several reasons have already been given for insisting on obtaining some revenue from privatization for the government's budget.

If the government simply gave away its assets, there would be an increased fiscal deficit necessitating measures to raise tax rates in the future unless a reduction in government spending were in sight. Raising tax rates would not be desirable from a supply-side perspective nor would it help stabilize an economy in which newly-privatized enterprises would be

struggling to make profits while being saddled with extraordinary adaptation costs. It would also violate certain microeconomic tenets of efficiency in taxation which make it desirable to plan for tax rates to remain steady (see *von Furstenberg*, 1991, for elaboration). Tax smoothing is beneficial because the marginal excess burden of taxation rises at an increasing rate with the level of the tax rates in force. As a result, tax burdens are not just related to average tax yields but rise with the temporal dispersion of marginal tax rates as well.

Dealing with averages irrespective of individual variations is inappropriate in another sense as well. Consistent with the emphasis on individuals which the criterion of Pareto-optimality demands, it is not appropriate here to consolidate the interests of present and future taxpayers as would be done to demonstrate “Ricardian equivalence” in the academic literature (see *von Furstenberg*, 1991). Rather, if one person gets a piece of government assets, or a monetary gift of corresponding value, *now* and another pays later, we expect a predictable political response from each. Holding future taxpayers harmless is an attempt to forestall a negative reaction that could come as soon as they see higher taxes coming.

## 2. *Personal Indemnification*

Fiscal indemnification was required before not just for reasons of macroeconomic stability but also for reasons of intertemporal distributive justice. If there were no present indemnification, there would have to be higher future taxes or inflation. The incidence of these future costs could not possibly match the incidence of present capital grants, in either time or person. For this reason government asset giveaways would violate Pareto-optimality and raise redistribution as an issue of contention undercutting political support for privatization.

While future taxpayers were thus included among those to whom the principle of Pareto-optimality in privatization was applied, that principle can become strained when applied to potential beneficiaries from the use of government assets farther down the road. Opposition to privatization from potential future stakeholders in such assets will be ignored because their interests are not likely to be represented politically. However, any particular personal interests already in evidence and politically legitimated through extended usufruct of government assets should be compensated or “grandfathered.” Otherwise the requirement of Pareto-optimality would fail to hold in the sense that is politically relevant for gaining support. Those who



have respectable rights and immediate benefits in government property should at least not be made worse off by its privatization.

An interesting example of the application of this requirement has been provided by the privatization law passed in Poland in July 1990. Under that law, privatization is initiated by the management and workers of government enterprises applying to the Minister for Ownership Changes to have their enterprise privatized. The Minister may approve if the enterprise is judged to be in a condition suitable for privatization and its stock issue can be put on the calendar without crowding other new issues planned. Although individual managers and workers may be outvoted in enterprises electing to go private, the process is initiated voluntarily by those most immediately affected by it. Stakeholders can thus, to a large degree, look to being adequately compensated or refuse to have their entity privatized.

Problems can arise with this consensual approach if the insiders are put in a position to block privatization and to appropriate gains from ownership transformation that should belong to society at large. Special consideration for insiders should be held in check by political newcomers laying out clearly to the public that giving more to insiders leaves less for all others.

### *3. Distribution of the Net Gains*

The first of the three principles enumerated required only that the state, i.e., future taxpayers, be held harmless for the net revenues the government gives up as a result of privatization. Similarly, principle (2) required that those who hold special and politically recognized privileges in government enterprises be compensated for giving up stakes that would have retained some value under continued government control. Even after compensating these two groups, net gains remain if privatization and deregulation conduce to the efficiency gains expected. How much of these gains the state is willing to pass to the people directly, and how they are distributed, will determine the strength and breadth of popular support for privatization.

Technically there are two principal ways of distributing the net gains and various combinations between the two. Under the social-dividend approach shares are sold to active investors, – those who are able and willing to acquire large blocks of stock and participate in corporate governance, – at the highest price consistent with the speed and rules chosen for privatization. The government then turns around and distributes some of the proceeds, lump-sum, to the population of voting age in the form of a social dividend that spreads the benefits of privatization, directly and in cash, to all.

Alternatively, under voucher schemes, the social dividend is granted in the form of shares, through stock dilution. This scheme is equivalent to selling all shares at market prices without the prospect of dilution and then turning part of the proceeds over to those otherwise receiving vouchers. The outcome could be distinguished from that of the social-dividend approach only to the extent vouchers are redeemed in stocks that are widely held and not immediately cashed in by small holders.

Under the second, the people's share approach not cash, but underpriced shares in individual or groups of enterprises are distributed to all adults. There is little reason for concern that, for lack of funds, even shares that are offered at prices well below market will not be bought by substantially all those entitled to subscribe to them under the egalitarian distribution scheme. First of all, a high percentage of the purchase price can be loaned by financial institutions and still have substantial security, because the loan applies to the purchase of an asset at a price substantially below market. This lowers the effective loan-to-current-value ratio or raises the margin requirement implied. Secondly the government itself can loan the money by stretching payment for the shares over months or years, as has been done for shares allotted to small subscribers to privatizations in the U.K. To cash out the benefits of privatization, the original share purchasers would have to sell their holdings at capital gains, and active investors would assemble blocks of shares by buying from the original subscribers. The expectation frequently affirmed by advocates of this approach is, however, that equities will remain broadly held.

Alternatively, the two approaches can be combined by having a government-asset disposition trust sell its holdings directly to active investors but distribute shares in itself for a low subscription fee to the voting-age population. Of course there could be more than one such trust, and vouchers could be issued to the population to acquire (a percentage of) the shares of these trusts, possibly with co-payment. As under the people's share approach, voters would thus obtain underpriced shares, though not in the underlying companies directly but in the trust (or trusts) charged with disposing of them. However, as the trust sells off its holdings and settles its obligations, including remittances to the state required to meet constraints (1) and (2), it would distribute whatever is left to the holders of trust shares as a liquidating dividend. Tax incentives might, of course, be provided for the people to reinvest, in the shares of companies in the private sector, the final dividend they receive from dissolution of the government's privatization trust. This mixed scheme would thus start with indirect people's shareholding in government enterprises and terminate with a social divi-

dend, possibly reinvested in private shares, for those who have not sold their trust shares in the interim.

Giving the people a residual claim in one way or another and an expectation that privatization will add to their personal wealth will help reveal the time cost of money, i.e., the balance they would like to see struck between time and money. They will have to decide between their desire for a speedy transfer of wealth, on the one hand, and precision and fairness in the way individual state enterprises are sold to collect that wealth, on the other. Coming to an agreement on this point will help protect the process from both the rent-seekers of state capitalism who would bog it down and the penny-wise accountants and inveterate bureaucrats who do not appreciate the need for a rapid transformation of the cues on which the economy acts. The remainder of this paper will show how divestiture has proceeded and its speed been managed in the case of public housing and industrial assets partly by the terms offered.

#### IV. Privatizing Public Housing for its Tenants

The basic principles of the concessional approach to dismantling state ownership and government control over the economy and over people's lives can perhaps best be explained not with socialist industry in the East but with public housing in the West, specifically in the United Kingdom. In contrast to the value of socialist combines, the market value of individual housing units in the U.K. is rather easy to establish and comparatively certain. Until about 10 years ago, one-third of all housing units in the U.K. consisted of low-rent public housing that provided a ticket to heavy subsidies from the general taxpayer. In spite of the popularity of such "council" housing with those who benefitted as either residents, contractors, or political providers, Prime Minister *Thatcher* found a way to make privatization acceptable. A million and a quarter units and their tenants were transferred to the private sector in her first ten years in office through 1989. The privatization of what amounts so far to one-fifth of the total stock of council housing has been achieved with the lure of a partial asset giveaway: Tenants were allowed to buy their units at discounts of up to 70 percent from appraised market value.

##### 1. *Privatization and the Gains from Trade*

Both the tenants and the U.K. Treasury, i.e., the general taxpayer, have benefitted from this ongoing privatization as *Butler* (1987) has pointed out.



The Treasury recouped at least part of the capital value remaining and shed the obligation to continue to provide operating subsidies. Certain graduated recapture provisions for resales within less than 5 years aside, tenants benefitted from concessional privatization even though it precipitated the termination of government subsidies attributable to their units. The present tenants would have been subsidized only so long as they continued to live in public housing. Having no ownership – but only personal-use – rights, they could not have realized the capital value of the expected future subsidies associated with the unit when they had to move out. In choosing to own, tenants may thus have discounted future benefits over a much shorter time horizon than the Treasury, and they may also have applied a higher discount rate. These differences left an opportunity for exchange profitable to both parties which was seized through privatization.

## 2. *Efficiency Gains*

In addition, housing services are likely to be supplied more efficiently by owner-occupied units, whose upkeep protects an occupant's personal investment, than by rental units in public housing whose maintenance is charged, in part, to society. Such a desirable change in behavior, that lowers cost and raises care, is what has attracted officials in other countries, most notably U.S. Secretary of Housing and Urban Development *Jack Kemp*, to the idea of privatizing public housing through a partial asset giveaway along lines recommended by the President's Commission on Privatization (1988, pp. 16 - 20).

As with housing, it could be profitable for the Treasury, and economically efficient for society to buy-off workers whose excess wages contributed to the losses of government enterprises. This may be the best option to take if privatization would otherwise be blocked. Giving these workers a partial ownership stake in return for cutting their umbilical cord to government would conserve fiscal resources on a present-value basis. Such "load shedding" could be acceptable to employees if their ownership stakes, through efficiency gains associated with private operation, were expected to acquire a value sufficient to compensate them for their loss of economic rent at the work place. Just as with privatized housing, workers would have increased concern for the maintenance of the capital stock and enhancement of its value if, instead of having usufruct (the fruits of use), they had a negotiable ownership interest in the assets themselves. At the same time, the government may find it cheaper to buy-off workers whose expected duration of

employment with their enterprise is limited than to support inefficient enterprises indefinitely because they were not privatized.

It appears, therefore, that partial asset giveaways can be justified even if future taxpayers and the immediate stakeholders first must be held harmless. Indeed, the government should even be able to reduce future taxes because of the “load shedding” above. Moving from vague, and insecure, property claims supported by political influence to secure legal rights established through formal privatizations creates the self-assurance and opportunities necessary for the development of efficient production and functioning markets. Yet no such changeover is feasible unless a winning political coalition can be built around it.

In the case of council housing the rate of privatization has been one-fifth of the total publicly-owned stock in 10 years, or 2 percent per annum. Part of the reason for tenants’ being slow to take-up the government’s offer in the U.K. was that they were entitled to buy their units over an extended period of time, with subsidies continuing to be paid on their behalf as long as they had not purchased. Another was that some households found it difficult to amass the down-payment or to qualify for a mortgage, even though financing for the purchase of units was available. (In summer 1990, *Thatcher* proposed a “rent-into-mortgage” payment conversion scheme to address this problem.) Most importantly, the depth of the subsidy governs the rate at which tenants can be expected to seek to purchase their unit, a point developed below.

### 3. *Reservation Prices*

The Treasury may be thought to calculate a reservation price for projects and their units that is consistent with (1), the principle of fiscal indemnification. This price would be set at a level just sufficient to hold future taxpayers harmless for privatization compared with the fiscal situation under continued government ownership. Unlike under some conditions in the U.S. HOPE program (see U.S. Department of Housing and Urban Development, 1990), the local councils in the U.K. are not obligated to replace any housing units sold or to replace public-sector housing stock once it is run down. Hence their reservation price is equal to the site value of the project at the end of its useful economic life minus the operating subsidies and debt service which the Treasury would have to meet on behalf of public housing tenants until that time, all discounted to the present.

Relative to market price, the reservation sales prices, thus, would rise as a project nears the point at which it will have to be razed, thereby freeing its

site for sale. Raising the sales price as a percentage of the market price on any existing unit over time can reduce the incentive of tenants to defer purchase until shortly before they have to move out of their subsidized unit or until the government's offer expires. Except at the very end of a project's useful life, when privatization would simply mean selling the uncleared site to the private sector, the government's reservation price would be below the market price of the project. For relatively new and durable projects, it could even be negative if the subsidy stream expected is long and deep. In that case the Treasury (or local housing council) could profit from giving the project away to shed its obligations.

Tenants have reservation prices for their units in the projects too. If they decide to buy and therefore allow privatization to proceed, principle (2), that of personal indemnification, is necessarily observed since the voluntary nature of the purchase assures that they will be no worse off as a result. Ignoring recapture provisions, tenants will figure on losing the present value of subsidies while gaining ownership of a unit that can be sold without restrictions at market prices. The longer they expect to live in public housing, the lower the net value they would put on their unit in relation to its current resale value. Only if they need to move out "tomorrow" for any reason, would they be inclined to buy almost "at market." Assuming that comparable condominiums can readily be priced in the private sector, there would be little risk that the occupant buying the unit would end up with a loss upon resale.

#### *4. Expediting Privatization*

To meet constraint (1) there is thus a spectrum of projects whose units could be made available at reservation sales prices normally well below market. Depending on the project, discounts could range from 0 to 100 % of estimated market value upon privatization without loss of any money by the government on a present-value basis. On the other side, there is a distribution of reservation purchase prices by tenants all of which meet constraint (2). These prices are distributed over individual housing units and involve discounts ranging from 0 to some percentage normally well short of 100.

The exact percentage applied by any tenant depends on the length and depth of the subsidies expected for her or his remaining stay in the unit, the subjective valuation of the subsidy benefits relative to the cost of living in alternative private housing, and the subjective discount rate. "Expected remaining stay" is shorthand for tenants attaching a probability weight to being in residence in any future year, a weight that would, of course, decline



to 0 if they look far enough ahead. If the probability-weighted stream of these subsidies forgone is valued  $x$ , and the estimated resale value of the unit is  $2x$ , the tenant would not be willing to pay more than 50 % of the market value for the unit since she or he would be giving up a “vested,” i.e., politically recognized, right to future subsidies by buying it.

Given the distribution of buyers’ reservation prices, the more the Treasury seeks to obtain from privatization above what is needed for fiscal indemnification in the aggregate, the slower the pace of this process. On the other hand, privatization will proceed most rapidly if the Treasury charges no more than its reservation price for the units on average.

If all gains from privatization, net of fiscal indemnification, are appropriated by the tenants buying their units, as appears advisable in this instance, the general public could receive no concrete benefit, such as wealth transfers or future tax reductions. For lack of a residual, principle (3) would be bereft of application here. Nevertheless the solution could be not only Pareto-optimal, but politically optimal as well. For it would not be politically attractive to insist that public-housing tenants should share their gains from privatization with the, generally better-off, remainder of the population. The decency of any such “regressive” claim would be widely questioned in Western societies where residents of public housing are regarded as objects of social pity and “uplifting” them to self-reliant homeownership has wide political appeal.

It is interesting to consider how different this evaluation of the appropriate distribution of the gains from privatization could be in those Eastern European societies in which most housing is public and heavily subsidized regardless of the income of the occupant. Frequently those with the most access to housing benefit most, much to the chagrin of the rest of the population. Kornai (1990a, p. 81) takes up this grudge when he calls it “absolutely unjustified to sell state-owned apartments to tenants at a price that is but a fragment of the real market price” and lambastes any such practice as “sheer nonsense, especially in view of the fact that the same tenant had for decades been subsidized by the state through low rents.” Indeed, in Eastern Europe, tenure can often be passed on within the family.

The two distributional guidelines previously applied to privatization of public housing would have led to conclusions quite different from those drawn by Kornai. The reason is that, in the U.K., protection of the stakes of public-housing tenants is viewed as legitimate. In that case the presence of rent subsidies as deep as in Eastern Europe would have meant that buyers’ reservation prices would have been very low because tenants would be giv-

ing up deep subsidies by buying. The government agency that can save these subsidies, on the other hand, would have a seller's reservation price that is even lower (or negative) in relation to the resale or market value of the units. Hence, something close to an asset giveaway would be the only deal available if existing tenants' interests were to be respected in Eastern Europe as well.

Whether the stakes of insiders are viewed as legitimate thus makes a big difference to the terms that are viewed as acceptable in privatizations. These terms, in turn, are the principal determinant of how fast the process may proceed.

## V. Mobilizing Support for Privatizing Socialist Industry

Public-housing tenants, at least in the West, were originally allowed access to subsidies as a matter of social policy. Privileged workers and managers in socialist enterprises in the East, on the other hand, may be perceived by the populace more as leeches on the rest of society than as objects of social pity. In that case those who hold stakes established under a previous regime need not be compensated unless they are sufficiently powerful to block privatization even under the new regime. Excessive compensation can backfire because it may discredit democratic privatization with the rest of the population. Hence, respecting constraint (2) may not be obligatory here. Furthermore, as already discussed at length in section III.1, the fiscal indemnification required under (1) may be small in relation to the market value which government enterprises may achieve in privatizations. This will hold even if a large risk premium depresses market value because few of those who buy, or buy into, government enterprises can diversify the extreme valuation risks arising during economic transformations.

### 1. *Uncertain Valuations*

Unlike public housing, it is almost impossible to determine beforehand the market value of individual socialist enterprises in private hands. Some enterprises may go bankrupt after the withdrawal of subsidies and protective regulations while others may attract new investment from both foreign and domestic sources to make them able to compete in the open economy. Difficulties of valuation, either as going concern or for breakup, are compounded because the values of the underlying tangible and intangible assets of many of these enterprises are also only beginning to be established in free markets as privatization and price decontrol proceed. Under these condi-

tions it may take years before one can distinguish an entity that is bankrupt from one that will turn out to be a gold mine with a high degree of certainty.

However, because of offset in appraisal errors, the market value of socialist industry as a whole may be sufficiently calculable to leave ample room for concessional privatization even after meeting constraint (1), and, with far less force than in public housing, constraint (2). What is most distinctive about privatization of socialist industry compared with public housing is this: Even though the ultimate market or resale values are uncertain, a good part of the financial benefits expected from privatization can be transferred directly to the population at large. Doing so would help build broad support for privatization, as required under (3). The question is how this can be done, given the valuation uncertainty, without violating prior constraints. These constraints include not only the obligation to provide fiscal indemnification for future taxpayers but also the obligation to ensure that those who support privatization on selfish grounds are, in fact, benefited with a high degree of certainty and do not feel duped in the end.

## 2. Combining Equality and Efficiency

A market-based incentive system of rewards and penalties is spontaneously, though not institutionally, disequalizing. There are a few special situations, however, in which equality and efficiency stand not in opposition but in support of one another. The privatization of socialist industry provides such an opportunity for mutual reinforcement. An equal distribution of initial stakes could impel transition to greater efficiency. The model under which it can do so is that of people's privatization, – a direct precursor to what is already known as people's capitalism (*Hanke*, 1987) in a people's capital market (see *Aharoni*, 1988, p. 41), particularly in Western Europe.

People's privatization would convert state holdings of industrial assets, collected in a privatization trust for reorganization and marketing, to property that is, at first, owned by the trust but then sold for the financial benefit of potentially all (adult) residents of a country. The shares of beneficial, but otherwise passive, participation in the trust distributed at the outset would grow in value as the trust sells its individual holdings to the highest bidders. Making privatization the engine for creating capital gains for potentially all the resident nationals of a country would put political impetus behind it and save it from the taint of unfairness.

*Blanchard* and *Layard* (1990) have addressed worries that an initially egalitarian wealth distribution would be destroyed by poor people's dumping their allotments almost upon receipt, while rich people buy the shares



cheap and get richer as they hold them. To limit disequalization they suggest that equal numbers of shares in a few holding companies or privatization trusts be given to everybody, including children, but with children barred from selling theirs. While issuing extra shares to families with children, like child support, may be politically attractive, issuing nontradable shares to children would waste some of the wherewithal for gaining political support for rapid privatization when it is most needed. For this reason, limiting the distribution of shares to all adults or even to all registered voters is politically more efficient.

Government-asset giveaways have been given different names for legitimation and appeal to particular groups. In a comprehensive survey, *Pirie* (1985, pp. 47 - 49) lists "giving to the public" as the fifth of 22 methods of privatization distinguished. He notes that giving away whole industries, even those that would have considerable value in private hands, has been suggested by many conservative thinkers. One of the most prominent of these, *Friedman* (1989, p. 577), has since called giving government-owned enterprises to the citizens his own "favorite form" of privatization. Conservatives tend to view efficiency gains from privatization as so large that it is unwise for society to wait for them. While accepting privatization by hook or by crook as long as it is fast, they recognize that unchallenged property rights are not likely to be established on a heap of insider wheelings and dealings that the rest of society views as defrauding them of their just inheritance from the state. Even with the most conservative thinkers, a substantially egalitarian one-time distribution thus is a recurring theme.

Egalitarian appeal also underlies proposals for homesteading (e.g., *Rothbard*, 1990) in Eastern Europe and suggestions of voucher (e.g., *Moore*, 1990 and see *Drabeck*, 1990, pp. 7 - 8) and social-dividend (*Farrell* and *Schaes*, 1990) schemes. Terms such as people's privatization, equal-shares (*Stolper*, 1990), or socialist (*Feige*, 1990a) privatization have a similar ring. They emphasize the restitution of state property to the people at large. Government asset giveaway has been recommended under these names also in cases where, in the view of the proponents, those targeted to acquire ownership would not have the money or financing to take up their stakes from the state or where equity markets did not exist until the government's asset giveaway put equities into play.

Focusing more on efficiency aspects, *Hinds* (1990a, pp. 47 - 50) and *Dhanji* and *Milanovic* (1990, pp. 22 - 36) have provided the most thorough recent discussions of the entire approach and some of its immediate alternatives. *Saldanha* and *Milanovic* (1990), *Vuylsteke* (1990, pp. 20 - 22), and *Hinds* (1990b) have given further thought to the organization of the state's

holdings for rapid privatization and to competition policy prior to the appointment of management beholden to private owners at the enterprise level. *English's* (1991) "privatization by general fund", on the other hand, emphasizes financial modalities and the roundaboutness of the process that makes those who end up owning and using the industrial assets acquired from the government's holding trust pay "full price". This outcome can be achieved by having the privatization trust sell its industrial holdings to the highest bidder, foreign or domestic, as value is brought out, with the sales proceeds, net of any debts to be settled by the trust, then passed through to potentially all the adult resident nationals of a country.

What *Feige* (1990b; 1990c) and *English* (1991) pointed out in this way is this: It is possible to give away collectively (negotiable, but initially not redeemable, shares in the privatization trust or closed-end investment company of speculative value), for the sake of equality and broad political support, what can and must, nonetheless, be bought at market prices individually (shares in the individual enterprises bought, mostly by active investors, from the trust) to assure efficient allocation and use of capital. By decoupling the dispersed holdings in the trust from the, quite possibly concentrated, acquisition of individual-company blocks of shares sold by the trust, principal-agent problems of operational control could be overcome (see *Dhanji and Milanovic*, 1990, p. 26). Thus using the initial degree of freedom, provided by the availability of government assets, for egalitarian distribution need not get in the way of efficient combination: rather, an equal start would promote the process of privatization on which efficiency gains depend.

### 3. Combining Fiscal and Investor Indemnification

In the spirit of people's privatization, the process should not start by transferring to the mass of individuals risks so large and incalculable that quite a few of them may realize losses on their original subscriptions from which it was rational to expect gains. This injunction, however, does not mean that individual government enterprises or shares in holding companies or asset trusts must be given away just because of bankruptcy risk or because the shares might turn out to be very nearly worthless once the debts are settled. Rather, the price can be set in such a way that the proceeds expected to be derived from the shares will meet the requirement of fiscal indemnification while still getting widespread acceptance of these shares from the population at large. What follows holds equally for (i) direct privatization of individual government enterprises through "people's shares" that are rationed out to as many eligible adults as will apply for them, and (ii) roundabout privatization by general fund or trust.

Technically, what is given away in these instances is equivalent to a call option whose strike price is equal to the tax payment required per share. If this “option” did not have a fixed expiration date, the strike price would have to be raised over time to prevent tax erosion that would tend to lock buyers into the originally-issued shares and deprive the government of receipts of predictable value. Either way, the payment intended for fiscal indemnification would be due only upon first resale of the stocks, which would be equivalent to exercise of the call option in the idiom used above. The buyer would receive a new stock certificate free of contingent tax lien once the tax had been paid. Some of these tax-free certificates should also have been given immediately to institutions or foundations operating in the public interest, and to banks in exchange for government-enterprise debt, to start a market.

If the value of such tax-free stock certificates did not reach the amount of tax due, taxable stocks would not be sold, and no tax liability would be precipitated. In this way it would be assured that those accepting stocks or privatization-fund shares could only gain, not lose, the first time around as they would make no down-payment to acquire the shares originally issued.

If the value per nontaxable share, say in the first 2 years after issue, had stayed below the tax liability but above zero, that liability could be reduced to the average value in the second year, or less, to prevent indefinite lock-in for taxable stocks. It would also be possible to impose a capital-gains tax upon sale, having given shares in the privatization trust a cost basis of zero. I would not favor such a tax because it applies at the margin, its yield is difficult to project, and it is a bad habit to get into. Still this shows that it is not difficult to think of ways in which the commandment, “Thou shalt not lose from people’s privatization,” could be quite strictly observed while still indemnifying the Treasury and future taxpayers.

Lack of personal buying power, thus, can be overcome and so can much of the valuation uncertainty. The uncertainty of tax yield that derives from the uncertainty of valuation of government enterprises can be reduced most easily if there is an all-encompassing, and thus maximally diversified, privatization trust. Setting tax liability on a single-trust share will help achieve fiscal indemnification with a much higher degree of certainty than fixing different speculative tax amounts for shares in less diversified trusts some of which may become worthless. The question of how properly to motivate the unitary government privatization trust – or rather the several competing divestiture-management companies it should commission to sell the trust’s various holdings and liquidate it – need not concern us here. Once there is a clear mandate for rapid divestiture, such questions can be submitted to the



competent advice of investment houses and underwriters in London and New York.

#### 4. *Vouchers to Deal with Monetary Overhang?*

Privatization could be used to reduce monetary overhang in some of the socialist shortage economies by getting people to pay for shares right away. To produce the monetary contraction required to avoid general inflation when prices are decontrolled, the government could use the proceeds to repurchase public debt from the state banking system. The entire operation thus would end up shrinking the financial assets and liabilities of the state banking system and contract the money supply by substituting government real for monetary assets in private portfolios.

Auctioning off shares to domestic residents is often criticized as favoring those who managed to enrich themselves through abuse of power under the former, socialist regime. Yet the critics rarely offer alternative solutions to the problems presented by monetary overhang and ill-gotten gains. Nevertheless, insisting on cash in advance would rule out combining the allure of equality with the benefits of efficiency in generating popular support for privatization to transform socialist economies.

In preparing for German monetary union early in 1990, the central bank developed plans that would have combined (the avoidance of) monetary overhang and “people’s privatization” in an interesting way. Residents of East Germany would have been given buying power over shares in the East German enterprises to be privatized *in lieu* of creating a monetary overhang through conversion of East (German) Mark into DM at an undesirably high 1:1 rate. Although this plan eventually came to naught, it is worth describing in some detail.

To prevent contributing to raising the money balances of East German residents well above those they would be expected to hold in view of their expected income and new portfolio-diversification opportunities, the German Central Bank (Deutsche Bundesbank, 1990) preferred making the monetary exchange at a 2:1 rate. Then 1 East Mark would command only 0.5 DM immediately, but this exchange would be sweetened with low-interest bearing certificates for the balance. These five-year certificates-of-deposit (CDs) would bear a below-market interest rate of around 3%, and a face value equal to another 0.5 DM per East Mark exchanged. They would be redeemable in stock of formerly government-owned enterprises for at least five years, starting soon, after issue, or in cash (at par) with the privatization fund, but only *after* 5 years. In the latter case, the privatization fund would

draw on the cash assets already accumulated from the sale of shares in individual enterprises to groups of active investors and borrow in the capital markets as needed to redeem in cash any of the CDs presented.

To direct redemption to stocks, an equity-conversion premium would be granted implicitly by allowing the CDs to be used at face value to purchase stocks at market prices well before the end of the five-year waiting period that would apply before there could be cash redemption at par. Shares in formerly East-German government enterprises would first have to be brought to market by selling to the highest bidders, with only a portion reserved for redemption of CD claims arising from the conversion of money balances by East German residents. These redemptions would then take place at the prices established in the underwriting.

With the Bundesbank plan rejected in favor of 1:1 exchange for most of the money balances of East German residents, privatization ceased to be a matter for the people. Through the spring of 1990, the then still East German “fiduciary institution” (*Treuhandanstalt*), or privatization trust, barely moved, intending to hold back any proceeds from privatization to subsidize operating deficits and to restructure the trust’s vast holdings. In this way, public-sector waste, insider featherbedding, and political manipulations could have continued for a long time.

The fiduciary’s law and management were changed in July 1990. The new law required the immediate breakup of the socialist *combinates* into share companies or limited-liability companies that would at first still be wholly-owned by the trust. Establishing such companies involves fixing their assets and liabilities and then proceeding to an examination of the entire business, management and accounting systems being instituted. Passing this examination allows the initial balance sheets and income statements, that form part of the prospectus for privatization, to be approved.

Since July 1990, the trust has made large working-capital loans to the businesses it owns, many of which would otherwise be failing. The enterprise losses financed by debt claims taken on against the trust’s assets substitute in part for unemployment insurance and related benefits that would otherwise have to be paid from the general budget or the social trust funds. Keeping failed government enterprises going is an indication that fiscal and personal indemnification have won out over people’s privatization. Had an expectation of the latter been allowed to become concrete and attractive to the East German public, it could have kept competing uses of the proceeds from privatization in check by counterbalancing both the fiscal claims of the state and the personal claims of stakeholders in government enterprise.

## VI. Conclusion

The Pareto-optimal approach to privatization, taken with exception when it calls for respecting even those established interests that are not viewed as politically legitimate, can yield a procedure for maximizing political support for the program. It immediately leads one to identify stakeholders that must be compensated: first the government in the name of future taxpayers, and second those who hold a direct stake in the assets the government is about to privatize.

The case study of public housing units sold to their tenants in the United Kingdom shows how the compensation scheme can be varied to put pressure behind the process when the prospective resale value of assets to be privatized is fairly certain. In the privatization of socialist industry considered in the second example, valuation is uncertain. There the general public can be made a beneficiary of the value that remains from the disposition of public assets after those stakeholders have been compensated whose interests are viewed as legitimate.

Concessional privatization can fall far short of asset giveaway and still assure that broad support is maintained for the program. For instance, subscribers can be insured against being made worse off by being asked to pay something for the shares they have accepted in formerly-socialist enterprises or asset trusts only if the shares turn out to be worth reselling. Payment would be made by means of a first-time stock transfer or conversion tax that is equivalent to the strike price set in a call option on shares.

Measures of this kind can help guard the egalitarian ethos and political appeal of people's privatization through which efficiency and the end of state-imposed egalitarianism in economic affairs is to emerge. Strong political support, in turn, should impart speed to the process. Brisk progress with privatization is necessary because much of socialist industry, suddenly called to struggle in an open economy, is a rapidly wasting asset. The *Blue Ribbon Commission* (1990, p. 26) has recommended that in five years at least one-half of presently state-owned enterprises should be in private hands in Hungary, while Poland is reported to be seeking the same result already by the end of 1991 (see *Wolf*, 1990). Whether either of these ambitious goals can be achieved to a substantial degree will depend on devising plans that can command broad political support in emerging democracies. This paper has attempted to lay out considerations relevant to marshalling such support.



## References

- Aharoni, Y.: "The United Kingdom: Transforming Attitudes," in R. Vernon, ed., *The Promise of Privatization*, New York: Council on Foreign Relations, 1988, 23 - 56. – Barr, N.: *The Economics of the Welfare State*, Stanford, CA: Stanford University Press, 1987. – Blanchard, O. and R. Layard: "Making it Safe for Capitalism," *Financial Times*, July 11, 1990, 15. – *Blue Ribbon Commission*: *Hungary in Transition to Freedom and Prosperity*, Indianapolis: Hudson Institute, April 1990. – Bobinski, C. and M. Wolf: "Radical Options for Privatization," *Financial Times*, August 2, 1990, 10. – Bofinger, P.: "Konzentration der DDR-Wirtschaft auf eine Holding mit Privatisierungszweck," *Handelsblatt*, February 3/4, 1990, 10. – Brainard, L. J.: "Strategies for Economic Transformation in Eastern Europe: The Role of Financial-Market Reform," unpublished, New York: Bankers Trust Co., June 5, 1990. – Brittan, S.: "Privatization: a New Approach," *Financial Times*, November 17, 1983, 25. – Brittan, S.: "The Politics and Economics of Privatization," *Political Quarterly*, 55(2), April-June 1984a, 109 - 128. – Brittan, S.: "The Case for Capital Ownership for All," *Financial Times*, September 20, 1984b, 27. – Butler, S. M.: "Changing the Political Dynamics of Government," in S. H. Hanke, ed., *Prospects for Privatization*, New York: The Academy of Political Science, 1987, 4 - 13. – Crane, K.: "Privatization in Hungary," Paper presented at 65th Annual WEA Conference, San Diego, CA, June 30, 1990. – De Soto, H.: *The Other Path*, New York: Harper & Row, 1989. – *Deutsche Bundesbank*: "Vorschläge des Zentralbankrates zu einem Umstellungsgesetz," *Auszüge aus Presseartikeln*, No. 28, Frankfurt, April 3, 1990, 1 - 2. – Dhanji, F. and B. Milanovic: "Privatization in East and Central Europe: Objectives, Constraints, and Models of Divestiture," Paper prepared for the World Bank Group Conference on Privatization and Ownership Changes in Eastern and Central Europe, Washington, D.C., June 13 - 14, 1990. – Drabek, Z.: "Tailoring Privatization to a Country's Needs: The Case of Czechoslovakia," Paper presented at 65th Annual WEA Conference, San Diego, CA, June 30, 1990. – Dyba, K., Jezek, T. and D. Arbess: "The Second Czech Revolution," *Financial Times*, October 18, 1990, 12. – English, R. D.: "Privatization by General Fund: Economic 24 (3), 1991 Empowerment for Eastern Europe," *George Washington University Journal of International Law and Economics*, forthcoming Fall 1990. – Farell, C. and G. Schares: "Blueprints for a Free Market in Eastern Europe," *Businessweek*, February 5, 1990, 88 - 89. – Feige, E. L.: "Perestroika and Socialist Privatization: 'What is to be Done' and How?" unpublished, Madison: University of Wisconsin, January 1990a. – Feige, E. L.: "A Socialism with Private Property," *Wall Street Journal*, March 9, 1990b, A12. – Feige, E. L.: "A Message to Gorbachev: Redistribute the Wealth," *Challenge: Magazine of Economic Affairs*, May/June 1990c, 46 - 53. – Friedman, M.: "Using the Market for Social Development," *Cato Journal*, Winter 1989, 567 - 584. – Grosfeld, I.: "Prospects for Privatization in Poland," *European Economy*, No. 43, March 1990, 139 - 150. – Hanke, S. H.: "Toward a People's Capitalism," in Steve H. Hanke, ed., *Privatization and Development*, San Francisco: ICS Press, 1987, 213 - 221. – Hemming, R. and A. M. Mansoor: *Privatization and Public Enterprises*, Occasional Paper 56, Washington, D.C.: International Monetary Fund, 1988. – Hinds, M.: "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," Washington, D.C.: The World Bank, EMENA Discussion Paper No. IDP -0057, April 1990a. – Hinds, M.: "A Note on the Privatization of Socialized Enterprises in Poland," unpublished, Washington, D.C.: The World Bank, July 1990b. – Kornai, J.: *The Road to a Free Economy*, New York, W.

W. Norton, 1990a. – Kornai J.: “The Affinity Between Ownership Forms and Coordination Mechanisms: The Common Experience of Reform in Socialist Countries,” *The Journal of Economic Perspectives*, 4(3), Summer 1990b, 131 - 147. – Lindbeck, A.: “The Transformation from Socialism to Capitalism: Statement for the French Journal ‘Le Debat’,” Stockholm: Institute for International Economic Studies, University of Stockholm, January 15, 1990. – Moore, T. G.: “A Privatization Program for Gorbachev,” *Washington Post*, May 30, 1990, A12. – Myrdal, G.: “The Equality Issue in World Development,” *American Economic Review*, 79(6), December 1989, 8 - 17. – Nankani, H.: *Techniques of Privatization of State-Owned Enterprises, Volume II: Selected Country Case Studies*, World Bank Technical Paper No. 89, Washington, D.C.: The World Bank, 1988. – Ohashi, T. M.: “Privatization: The Case of British Columbia,” in S. H. Hanke, ed., *Privatization and Development*, San Francisco: ICS Press, 1987, 189 - 194. – Okun, A. M.: *Equality and Efficiency: the Big Tradeoff*, Washington, D.C.: Brookings Institution, 1975. – Pirie, M.: *Dismantling the State: The Theory and Practice of Privatization*, Dallas: National Center for Policy Analysis, 1985. – *President's Commission on Privatization: Toward More Effective Government*, Report of the President's Commission on Privatization, Washington, D.C.: U.S. Government Printing Office, 1988. – Rawls, J. A.: *A Theory of Justice*, Cambridge, MA: Belknap Press of Harvard University Press, 1971. – Rothbard, M. N.: “A Radical Prescription for the Socialist Bloc,” *The Free Market*, 8(3), March 1990, 1 - 4. – Saldanha, F. and B. Milanovic: “A Proposal for a Fast and Efficient Privatization of the State Sector,” unpublished, Washington, D.C.: The World Bank, June 1990. – Stolper, T. E.: “Transition to a Market Economy,” *The Christian Science Monitor*, May 11, 1990, 18. – Svejnar, J.: “A Framework for the Economic Transformation of Czechoslovakia,” *PlanEcon Report*, 5(52), December 29, 1989. – *U.S. Department of Housing and Urban Development, HOPE: Homeownership and Opportunity for People Everywhere*, HUD-PDR-1246(1), Washington, D.C., March 1990. – Vanous, J.: “Privatization in Eastern Europe: Possibilities, Problems, and the Role of Western Capital,” *PlanEcon Report*, 5(38/39), September 30, 1989. – von Furstenberg, G. M.: “Reviving East German Property,” *The Wall Street Journal/Europe*, March 8, 1990, 6. – von Furstenberg G. M.: “Taxes: A License to Spend or a Late Charge?” in R. G. Penner, ed., *The Great Fiscal Experiment*, Washington, D.C.: Urban Institute, 1991, 153 - 191. – Vuylsteke, C.: “Privatization in Emerging Market Economies: Constraints and Practical Responses,” Background Note for World Bank Group Conference on Privatization and Ownership Changes in Eastern and Central Europe, Washington, D.C., June 13 - 14, 1990. – Walters, A.: “Supply-Side Policies: The Lessons from the U.K.,” in G. von Furstenberg, ed., *A Supply-Side Agenda for Germany*, New York: Springer, 1989, 185 - 215. – Winfield, R. D.: *The Just Economy*, New York: Routledge, 1988. – Wolf, M.: “Journey into Terra Incognita,” *Financial Times* (World Economy Section 6), September 24, 1990, vi. – Yarrow, G.: “Privatization and Economic Performance in Britain,” in K. Brunner and A. H. Meltzer, ed., *IMF Policy Advice, Market Volatility, Commodity Price Rules and Other Essays*, Carnegie Rochester Conference Series on Public Policy, 31, Amsterdam: North-Holland, Autumn 1989, 303 - 344. – Yarrow, G.: “Three Lectures on Privatization,” delivered at the Institute of Economics, Jagiellonian University, and the Krakow Academy of Economics, Krakow, April 3 - 5, 1990. – Yotopoulos, P. A.: “The (Rip)Tide of Privatization: Lessons from Chile,” *World Development*, May 1989, 683 - 692.



## Summary

### **Pareto-Optimal Privatization for Gaining Political Support**

The events in Eastern Europe that came to a head in the fall of 1989 have sparked a search for privatization procedures that would speed the conversion from government to market-directed economies and help elicit a positive supply response by prying enterprises away from government bureaucracies. So far, however, no politically-successful approach to rapid privatization has been found. There is a high risk of coordination failure and political impasse associated with moving slowly. To reduce this risk, this paper explores how much leeway there is for building broad support for privatization by instituting a (Pareto-optimal) process from which many will gain and no one with a politically legitimate claim can initially lose.

## Zusammenfassung

### **Pareto-optimale Privatisierung zur Gewinnung politischer Unterstützung**

Die Ereignisse in Osteuropa, die im Herbst 1989 einen Höhepunkt erreichten, haben die Suche nach Privatisierungsverfahren ausgelöst, welche die Umwandlung von Staatswirtschaft in Marktwirtschaft beschleunigen und positive Angebotsreaktionen durch Abkehr der Unternehmen von der Staatsbürokratie hervorrufen helfen. Bisher ist jedoch noch keine politisch erfolgreiche Methode für eine rasche Privatisierung gefunden worden. Es besteht ein hohes Risiko, daß die Koordinierung versagt und daß sich politisch ausweglose Situationen mit geringen Fortschritten ergeben. Um dieses Risiko zu mindern, wird in dieser Arbeit untersucht, wieviel Spielraum für die Mobilisierung von Unterstützung der Privatisierung auf breiter Basis durch Schaffung eines (pareto-optimalen) Prozesses besteht, von dem viele gewinnen werden und niemand mit einem politisch legitimen Anliegen anfänglich verlieren wird.

## Résumé

### **Privatisation optimale de Paréto pour gagner le soutien politique**

Les événements survenus en Europe de l'Est fin 1989 ont fait jaillir une recherche de procédures de privatisation qui accélèraient la conversion des économies gouvernementales en économies de marché et aideraient à mettre en lumière une offre positive, entraînant les entreprises à s'éloigner des bureaucraties gouvernementales. Pourtant, on n'a pas encore trouvé jusqu'ici une approche politique qui permettrait une privatisation rapide. Il y a un risque énorme d'échec de coordination et d'impasse politique, associée à la lenteur du processus. Pour réduire ce risque, le présent article analyse quel est le retard à rattraper pour trouver un large soutien pour la privatisation, en instituant un processus optimal de Paréto qui permettra à beaucoup de gagner et qui empêchera qu'il y ait une demande politiquement légitimée, de perdre au départ.