

Political, economic and health consequences of different methods of making private property.

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The transition from state-socialism to capitalism was unique among all transitions to capitalism for two reasons. It was the first where there was no class of private proprietors, and it was the first where capital accumulation had already taken place on a huge scale. Crucially, in most cases this industrialization was obsolete and inefficient from a global perspective. In order for the transition to proceed, there had to be some strategy to transform the productive order into one recognizable as capitalist. This would be a massive exercise in social engineering, as large as any attempted, including the Stalinist period of industrialization and collectivization. Not surprisingly, different ways of transforming the property structure had different political, economic and public health consequences.

There were eight different ways in which this privatization was actually accomplished.

(1) The most straightforward was to privatize via competitive auctions. This typically occurred after a period of active restructuring. Some form of foreign ownership was often a natural outcome of this method (since they would be expected to win a large percentage of fair auctions because of their capital and experience).

This was the modal form employed in Hungary and Poland (see King and Snajder 2006).

(2) Non-competitive auctions. In many instances politically connected businessmen, the so-called “oligarchs,” are able to privatize enterprises via rigged auctions. In such cases, the price paid for the enterprise is incredibly low. This was the modal form of Russia’s raw materials sector in the now infamous “Loans for Shares” program in which the crown-jewels of the Russian economy, its oil and metals firms, were privatized by oligarchs in exchange for media and political support for Boris Yeltsin’s 1996 re-election bid (see King and Treskow 2006 for details).

(3) ESOPs. These are employee shared ownership schemes in which the employees gain ownership of the firm. Unlike ordinary management and employee buyouts however, there is a legal device that centralizes the ownership and voting of the workers. This is crucial, since it guarantees actual worker control. These were very rare throughout the postcommunist world, and were mostly prohibited in practice in Russia.

(4) MEBOs. Perhaps the most common form of privatization overall was management and employee buyouts. There were a variety of ways of accomplishing this transfer, but it almost always involved substantial discounts to enterprise insiders. In most cases, management or some outside owners would centralize the shares of the workers by slowly buying them up. Sometimes there would use lease-to-own arrangements, where managers and employees would lease the enterprise from the state until they paid an amount that made them its owners.

(5) FDI. Foreign Direct Investment. This is typically the outcome of fair auctions, but can also be accomplished in other ways. There can be a formal or informal preference for FDI (such as in Estonia, where FDI was sought as a hedge against

Russian domination). There can be FDI via closed tender, where the process isn't transparent but negotiated between the government and foreign buyer behind closed doors. FDI is the dominant method in Hungary, Estonia, and CEE more generally. FDI can also take the form Joint Ventures, often with State Owned Enterprises (this is very common now in China).

(6) Cross-ownership. Here, firms are allowed to purchase the shares of other firms, which in turn purchase the shares of their new owners. The result is a system of cross-institutional ownership where a group of firms own themselves. This in practice means the upper management of these firms control them from outside owners. This was observed in the Czech Republic (King 2001).

(7) Privatization via Greenfield investment. This is the strategy of not privatizing SOEs for quite a while, but creating conditions conducive to Greenfield investment and the exit of inefficient firms. In essence, this allows a private sector to grow up around a state owned sector, until the country "outgrows the plan." This is the dominant method in China.

(8) Vouchers or coupons. These were programs that distributed "vouchers" or "coupons" to the adult citizenry which can then be used to purchase enterprises during privatization auctions. Their face value was much greater than their cost to the public. This was the major method in Russia.

(9) Restitution. In some cases the legal title of some enterprises that had been nationalized by the Communist regime was returned to their original family of ownership. Another variant was to give vouchers to compensate for nationalized property that could be used to purchase other stocks. This was a very minor method overall.

It is important to keep in mind that all actual cases were mixes of these methods.

The donor community, consisting most importantly of the World Bank, The EBRD, and the IMF, would have preferred FDI. However, they expected that FDI wouldn't be of sufficient scale or rapid enough to get much of the job done. This was because there was so much uncertainty during the transition, that it was not that rational for foreign owners to make huge commitments. Secondly, they figured that organizing auctions for each firm would take far, far too long. Third, they didn't expect that selling everything to foreigners would be possible politically because nationalists would mobilize successfully against it. Because of these practical limitations on the scale of FDI, the donor community favoured the liberal use of vouchers often in combination with MEBOs.

They argued only vouchers could provide the necessary speed. Privatization had to be fast because continued state ownership was vastly less efficient than any form of private property, and thus this could undermine monetary stabilization by creating pressure for subsidies. In addition, workers and managers at SOEs could form a powerful coalition that would freeze the transition in an unacceptable sub-optimally efficient market-socialism, or could even lead to a restoration of the old economic order. That is, the old Red Barons (enterprise managers) and their workers could be a very powerful interest group shaping state policy.

These different ways of privatizing had an enormous consequence for the outcome of the transition.

Let us first consider the most developmentally nutritious method: competitive auctions leading to FDI. While many left-wing pundits and academics demonized MNCs as the agents of exploitation and underdevelopment, the empirical evidence has not born this out. The theory of FDI as neo-colonial domination expects MNCs to repatriate profits, and to kill off domestic firms by substituting their own supplier

firms located in other countries in the multinational empire. Of these fears, only the latter seems to be plausible. Indeed, the biggest profit exporters in the postcommunist world are politically connected insiders or “oligarchs”, as will be explained below. The upside of foreign ownership turns out to be massive. They have ample funds for badly needed restructuring, access to the best technology in the world, and access to the high profit markets in the advanced capitalist countries. For example, in one random sample of Polish firms conducted by the World Bank, foreign owned firms were 190% more likely to increase sales, 322% more likely to increase exports, 395% more likely to increase their number of employees, 120% more likely to make investments, and 244% more likely to have very high profit margins (>20% return on assets) than domestic private firms (King and Snajder 2006, p.786). As for the supposed negative effects of state ownership, the same analysis didn’t support this idea. That is, factoring out foreign ownership, domestic private firms did not outperform state owned firms. In fact, there were no statistically significant differences between state owned enterprises and private domestic firms, except in job creation.

There is no major political effect of competitive auctions leading to large amounts of FDI. However, the absence of an effect is itself newsworthy in this regard. As we will see below, other methods are not so benign. Also noteworthy is that there is good empirical evidence that foreign owned firms have a much greater propensity to pay their taxes and to not retreat to barter and inter-enterprise arrears – much to the benefit of the state budget.

Finally, the empirical work has not been completed yet linking FDI with public health outcomes. To the extent they support state capacity, this has an indirect positive effect on public health. To the extent they lead to successful economic

restructuring, this should have direct and indirect effects. Indirectly, a growing economy pays more taxes, again contributing to state revenues. Directly, employees in successful firms will not suffer the stress induced by firm failure. Cutting against this might be greater insecurity of job tenure.

If competitive auctions are the best way to privatize, non-competitive auctions are certainly the worst. Because non-competitive auctions are by their nature illegal, they result in very insecure property rights. This is because the new owners know that they might lose their property with the next change in the political winds, or at least political patron. Their property can always be renationalized and then re-privatized because it was obtained in ways that typically violated the law. The logical way for owners to behave in this scenario is to pillage as much from the privatized company as quickly as possible, without any concern for the long-term functioning. In essence this amounts to massive asset stripping, tax evasion and capital flight (about \$40 billion annually in Russia through the 1990s).

The political repercussions are also quite serious. First, because the firms were major revenue generators, and because the price paid to them was so insignificant, this amounted to a giant fiscal crisis for the state. Furthermore, the creation of patron-client ties linking politicians or state officials and “oligarchs” by definition leads to an erosion of the formal Weberian bureaucratic nature of the state (e.g. separation of office and officeholder, etc) and therefore its effectiveness. Finally, this will create a group of very powerful private actors with a huge incentive to do everything, legal and illegal, in their power to ensure their “their” political patron stay in office.

Such negative economic and political outcomes could not fail to leave a mark on public health as well. By weakening the state, they weaken state provision of health services as well as state infrastructure, both of which contribute to adding to

the burden of disease in society. In addition, there is some evidence that these enterprises systematically exploit their employees by withholding wages, and by not paying local taxes. This leads to increases in local poverty, and thus the burden of disease. This has all been played out in all its tragic and absurd details in Russia, as the Yukos case demonstrates (see King and Treskow 2006 for a detailed case study of the Russian oil sector).

The donor community was split on these non-competitive auctions. While the World Bank and some prominent neoliberals like Jeffrey Sachs opposed the “loans for shares” privatizations, the IMF must bear the shame of actually supporting this policy on the grounds that it raised some revenue for the state and created private owners.

The majority of the Russian economy was privatized via a huge voucher scheme. The obvious economic problem with this method is that the new owners have no capital or new experience. Shares were widely distributed to inexperienced owners with no available means to see that their interests are represented and no availability to crucial information (see King 2003 for details and case-studies from Russian firms). Without any infusion of capital, such ownership was likely to lead to catastrophic performance in the new, incredibly competitive liberalized domestic market.

A devastating consequence of mass privatization was that this eliminated the state’s most important mechanism for extracting resources (taxes) from society. That is, profitable SOEs funded the state. With privatization, the state lost its ability to tax enterprises in this way. Unfortunately, the new system of taxation was not yet in place long enough to function well. Because of the collapse of state capacity resulting from mass privatization, a functioning tax system would be many years away.

The consequences for public health appear to be massive and are completely unexpected. Robust evidence now exists at the cross-national level linking mass privatization programs to a catastrophic leap in mortality rates (King et al. 2006, King and Stuckler 2007, Stuckler et al. forthcoming). What is less clear is the exact role of each mechanism linking this policy with the premature deaths. First, privatized firms will fire many people as a first move to regain market-competitiveness, killing people. Unemployment is a known stressor and thus associated with stress-related deaths – alcohol, suicide, ischemic heart disease (Stuckler et al forthcoming). However, there are other paths between mass-privatization and elevated mortality. First, general stress resulting from the dismantling of social benefits – healthcare, education, vacations. The first thing privatized firms did was get rid of these socialist-era institutions which weren't profitable, passing them on, in theory, to the local government. But since most local governments were to go bankrupt, that didn't leave much. Second, stress induced by a failing economy in a vicious cycle with a failing state (increases in crime, violence, decay of infrastructure).

What of the other ways of privatizing without relying on capitalists? Perhaps the most wide-spread method was MEBOs, management and employee buyouts. By itself, it is hard to see how this will lead to much restructuring as the new owners have no capital, no additional knowledge, no distribution networks. Experience shows that MEBOS will likely turn into management ownership over time as shares are concentrated, or might be taken over by a hostile outsider.

ESOPs are at least potentially better economically and for public health. However, there is little empirical data on this, and at any rate they were a fairly minor privatization strategy. Economically, the advantage stems from the fact that they fully internalize principle-agent externalities. That is, they are able to police opportunistic

behaviour, since one tends not to steal from oneself. This should also lead to health benefits because increased control should decrease stress. One can also expect a bias against firing workers, and decreasing unemployment, will decrease population level stress and thus stress related diseases.

Privatization via cross-ownership has not been studied persistently and most importantly not persisted long enough for us to know the economic, political or public health consequences. In the Czech Republic, where some of this cross-ownership was identified (King 2001), the state re-nationalized these firms and sold them to foreign companies. Privatization via restitution was also far too small to have much of an effect.

Finally, privatization by “growing out of the plan” – greenfields combined with the normal functioning of the market economy (mergers and liquidations) – should provide the least disruption to the economy. To the extent SOEs continue to fund healthcare, public health should not be adversely impacted.

In conclusion, we can see that how privatization was carried out had gigantic consequences. Not only the speed, but the type, of privatization was probably the decisive policy explaining postcommunist divergence. The donor community, and economic policy makers more generally, completely overlooked this crucial fact. Most economists instead focussed on the need for speed in privatization, most importantly for political rather than economic reasons. We can now see that this concern was completely misplaced, and in fact counterproductive. Poland and Slovenia were very slow to privatize their large firms, but there was no political coalition that blocked the emergence of a fully capitalist society. To the contrary, the rushed privatization in Russia created powerful private actors that were responsible for undermining free and fair elections in that country.

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