

FROM IMPOTENCE TO OMNIPOTENCE:
THE STATE AND ECONOMIC TRANSITION, 1989–1994

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The economic transition introduced after the fall of the Communist regime aims at supplanting past state ownership with new owners able to transform industrial production to meet the requirements of the market. In the planned economy, public ownership had always been an empty phrase. What happened gradually was that the centre lost power to instruct and control the enterprises, the latter supplying the planners in Prague with data tailored to further the interests of the enterprise sphere. In particular in the 70s and 80s, the state was reduced to an impotent coordinator, and the economy was more centrally administered than planned¹. During the brief time since 1989, a stream of changes in the formal institutional structure has been initiated. These changes have been directed toward recreating the basic parameters of Western market economies; e. g. removing price controls, freeing the central bank from political supervision, enacting legislation to protect private property, etc. This period, from late 1989 to the end of 1994, marks also the finalization of the "second privatization wave". Precisely the withdrawal of state ownership has been declared to be the major instrument of changing the economy. Only thus could, what was called "the economy of social indolence" which had permitted the enterprises to degenerate into social institutions, be terminated². It is the changing balance of state and non-state in the years since 1989 that will be analyzed here. Attempts will be made to show how extensive state control has been in the course of transition. The anti-state rhetoric of Prime Minister Václav Klaus has at all stages been particularly strong³. As will be shown, this has granted considerable autonomy to managers when preparing their enterprises for sale. On the other hand, for various reasons, the government has prevented the introduction of market mechanisms that can result in the closure of unprofitable units, thus keeping unemployment and social tensions at a remarkably low point. This is achieved in two ways, one being a very confusing muddle of crossownership of enterprises, investment funds and banks, the second the lack of efficient bankruptcy legislation.

The considerable role played by the state during the whole transition is per se no reason for criticism. There was no propertied middle class in the Czech lands to push

¹ An excellent analysis is Mlčoch, Lubomír: *The Behaviour of the Czechoslovak Enterprise Sphere – A survey of microeconomic works of 1968–89*. Prague 1992.

² *Ibid.* 382.

³ For a discussion of the basic tenets of Václav Klaus' approach, see Martinsen, Kåre Dahl: *Václav Klaus und die politische Stabilität in der Tschechischen Republik*. Osteuropa 11 (1994) 1057–1070.

for reforms, no private share of the market that could be trusted to expand and rapidly supplant the state as owner of the large industrial enterprises. The importance of the state as carrier of the reforms was therefore evident right from the start of transition. It was clearly up to the government to be the first mover, relying on the legislature to make appropriate legislative changes and thus formally change the property rights. It was the task of the executive, the state bureaucracy, to take care of the implementation. At the same time the executive branch itself was changed utterly in the course of transition; new entities were created while others were dismantled.

This underlines what may be called the double paradox; the government was obliged to use the state bureaucracy in order to withdraw the state from industry. Thus, the state had to be given the tools required to implement the institutional changes by the government. This poses the question whether the government is technically capable and politically able to do this⁴. Technical capability refers to the overall transition strategy and the quality of the separate measures aimed at transforming property rights, the political ability and the political strength of both the government and the forces opposing the changes. Furthermore, it should be asked whether the government is willing to let the state act as "a construction manager, dispatcher, programmer, laboratory assistant, tutor and arbitrator"⁵. After all, the past had taught all (including civil servants) to regard the state as interfering and blocking independent initiative. The dislike of the state, albeit understandable and easily explainable, made it difficult in the Czech political discourse to look at ways the state could be used to promote economic efficiency. State participation in economic development is regarded as indispensable in most market economies, yet a basic criterion is that the role of the state should be transparent and subject to clear-cut guidelines laid down by the politicians. Only thus can economic and political lobbyism be detected, and democratic control be exerted. Transparency, here understood as the ability to identify the ownership interests at stake in the transition, is what will be analyzed below.

It is important to underline the conceptual point of departure of the transition process: transformation of the economy and consolidation of democracy. Both raise a number of constituent questions that may be addressed separately, without paying attention to their inter-linkage. Yet as often is the case when the new property rights are analyzed without taking the political context into consideration, the conclusion ends with a mere technical summary of legal arrangements. Unless the legitimacy of the transitional measures are included as an explanatory factor, the analyst will not be able to explain why the final results may deviate from what could be regarded as economically the most optimal solution. This concerns the sale of state assets in particular, since the values at stake are so considerable that their allocation will have greater social consequences than any privatization undertaken in the West, no matter how comprehensive. It is therefore necessary to underline that retaining public support

⁴ See L ö s c h, Dieter: *Der Weg zur Marktwirtschaft, Grundzüge einer Theorie der Transformationspolitik*. Baden-Baden 1993.

⁵ K o v a c s, J. M.: Engineers of the Transition, Interventionist Temptations in Eastern European Economic Thought. *Acta Oeconomica* 1-2 (1992) 50. In L ö s c h: *Der Weg zur Marktwirtschaft* 28.

was imperative for the government. Public support for the reforms was useful, since it could weaken any resistance from the former industrial lobbies and the state bureaucracy. If, on the other hand, the government alienated easily definable social groups, the costs of circumventing their resistance would reduce the pace of reforms and maybe thwart them altogether. Furthermore, if a sufficient number of the voters were turned against the policy implemented, political instability would jeopardize the government's position. The danger of this happening was inherent in the transition itself. Immediately after 1989, analysts agreed unanimously that whereas it was difficult to identify just who stood to gain from the changes, the immediate future would carry with it hardships for most of the population⁶. Severing the links between the state budget and the enterprises would mean enterprise closure and large-scale unemployment.

It is therefore necessary to address how the government tried to involve both the population at large in the reforms, and more particularly, those groups in the state enterprises that were affected by the property rights. The changes and the redefinition of the role of the state were an attempt to create a corporate governance structure with a strong and market-oriented managerial layer, rendering impossible any reversion into the paternalism of the past. Such a development could not be taken as given. No large-scale exchange of bureaucrats or management occurred; there would not have been anybody to fill their place. Therefore, the formal institutional arrangements would have to be designed in such a manner as to provide those affected with incentives to restructure enterprise production. Providing the enterprises with autonomy is not synonymous with restructuring unless it is the interest of management to pursue it. The question is therefore what tools are available for the government to avoid alienation and to ensure adherence even after the enterprises have been provided with a greater say over their own affairs than previously. This question would have been unnecessary if the new owners could be relied upon to press management to undertake the changes required for the enterprises to become independent of state support. Although owners can be created quickly by providing them with some degree of ownership, an answer will depend on what their interests are and to what degree they are able to act cohesively to exert pressure on management.

Defining a strategy – "The Scenario for Economic Reform"

A so-called "Scenario for Economic Reform" was passed by Parliament in mid-1990⁷. It was permeated by an emphasis on speed. This was hardly unexpected, despite the reluctance displayed by Slovak politicians at the time. International financial organizations such as the IMF and the World Bank, and Western economists working as advisors to East European governments, clearly favoured a rapid transition⁸.

⁶ The Institute for Forecasting, in 1989 containing both proponents of shock-therapy and a gradual approach, at least on this in: Highlights of the New Socio-Economic Program of Development of Czechoslovakia. Prague 1989.

⁷ *Hospodářské noviny* 4 July 1990.

⁸ See Lipton, David and Sachs, Jeffrey: Creating a Market Economy in Eastern Europe:

They based their views on the urgent need to reduce the time between the dissolution of central planning and the emergence of market institutions since this would only create unpredictability for the enterprises and leave them in a state of limbo. Yet, in the "Scenario", the need for speed was not based on considerations for the enterprise sphere, but rather to avert social unrest: "The greater the speed and the more radical the manner of the implementation of the reform measures, the lower the total social expenditure the process of transformation is bound to produce"⁹.

The link between private ownership and a more efficient economy was given far less attention than the need to provide individual citizens with autonomy. State ownership was identified with state paternalism, the continued reliance of the enterprises on the state. Privatization was therefore taken to mean the opposite, cutting the links between the state and the enterprises:

Private ownership over the means of production is one of the main pillars of a market economy that functions well. However, in Czechoslovak society, state ownership dominates while the individual citizen's part in its production and use cannot be identified. This means that the intentions of the reform will be threatened if a fundamental change in these property conditions does not occur. Therefore . . . processes of the abolition of state control and privatization will be carried out¹⁰.

The general character of the "Scenario" meant that there were no clear guidelines on the future industrial policy the enterprises could expect would be pursued. The document did not bring any promises concerning state aid to ailing enterprises, nor was funding for structural adaption regions that could expect to be severely affected by transition mentioned. Omission was not restricted to these aspects; the "Scenario" did not identify industrial sectors the government would prefer to be reduced in relative importance. This is somewhat surprising since many government members, in their capacity as scholars before 1989, had argued particularly for the need to reduce the role of raw material excavation and heavy industry¹¹.

The "Scenario" failed to come up with any specific guidelines on how to privatize. This is understandable and not unexpected since the "Scenario" was intended as a survey of the transition, providing the fundamentals of rules and regulations to be elaborated at a later stage. Yet it was foreseen that privatization of small enterprises, shops and restaurants would be completed within a short period, a couple of years. For the larger enterprises, it was stated that the ownership would be changed in two separate stages. The first would be *commercialization* of the enterprises. By this was meant a transformation of the enterprise into joint stock companies with all shares owned by the state. The second and final step would be the *sale* of the shares to new owners.

It would be the responsibility of the state to undertake these two steps, and complete them in the fastest way possible. But this raised the question of how far state

The Case of Poland. Brookings Papers on Economic Activity 2 (1990) 293–341. Sachs has worked as advisor to the Polish, Estonian and Russian governments.

⁹ The Federal Assembly of the Czech and Slovak Republics: Scenario of the Economic Reform. Prague 1990. In: Olsson, Martin: Vad är en voucher? Kupongprivatisering i Tjeckien. Nordisk Østforum 3 (1994) 30.

¹⁰ Kučka, Martin: Transformation of Ownership in Czechoslovakia. Soviet Studies 2 (1992) 297–311, 298 quoting Hospodářské noviny 4 September 1990.

¹¹ Rudé právo 9 June and 30 July 1987.

responsibility for the enterprises extended. Since the price achieved would depend on the condition of the enterprises at the time of sale, would the state undertake the necessary measures and allocate the capital required to overhaul them? There was no answer to that in the "Scenario". Ending state ownership meant that the task of restructuring the enterprises would be the task of the new owners. At the annual meeting of the Czech Economic Society in late 1993, Klaus gave a summary of the events of the past years, declaring that transition had ended with the implementation of macroeconomic balance, liberalization of prices and foreign trade, as well as devaluation and limited convertibility of the currency. Klaus elegantly excluded enterprise-related problems from transition, even though he used the more comprehensive concept 'transformation': "Transformation concerns the system, the whole, and therefore transformation is neither modernization, nor reconstruction, nor the financial stabilization of individual firms, because these are all post-transformation tasks . . . That is the reason why privatization has a specific role in the whole transformation process which sets it apart from privatization in the West"¹².

The "Scenario" defined the aim of transition as a withdrawal of state ownership and control. How this was to be achieved was answered by the two-step strategy for the state enterprises. Yet several questions pertaining to the enterprise sphere during transition were left unanswered: what would the role of the state be during transition, what organs would exert control over the enterprises, how would the state attempt to solve the inter-enterprise debts inherited from planning, and who would be responsible for the privatization of each enterprise? It is these questions that will be answered below.

The Law on state enterprises

The plans for a new law on the state enterprises that had been enacted in the course of the timid reforms in the late 80s were implemented by the "Government for national reconciliation" in the form of a Law on state enterprises¹³. The Law was intended as a transitional measure, when the ownership status of the enterprises changed: i.e., when the state rescinded its ownership, other legal regulations would apply.

The Law defined the state enterprise as "a producer of goods which performs its entrepreneurial activity independently"¹⁴. The Law provided for increased managerial autonomy to make decisions concerning output and sales, and to enter into contracts which did not exceed the limits of "appropriate business risks"¹⁵. With the dissolution of the planning organs, management had been given extensive *de facto* autonomy. This was confirmed by the Law, though the state retained access to intervene if management actions were perceived as a threat to the viability of the enterprise. That did not imply that the state would monitor decision-making at the enterprise level to ensure that inappropriate risks were not taken. The state lacked the institutional preconditions for undertaking such a venture, which would inevitably have meant a

¹² Klaus, Václav: *Transformation Rules: The Hypothesis of Two Cushions*. Prague Economic Papers 2 (1994) 121–124, 122.

¹³ Law no. 111/1990, "On State Enterprises".

¹⁴ Frydman, Roman et al.: *The Privatization Process in Central Europe*. London 1993, 52.

¹⁵ *Ibid.*

continuation of the old stream of information and directives between management and the state. What was perceived to be of greater concern for the authorities was to prevent management from using its position to change the character of the enterprise by splitting it up into smaller units, retaining control only over what was most likely to be promptly privatized and leaving the rest in the state sector.

Furthermore, managerial autonomy was legally restrained by the detailed specification of the allocation of enterprise profits in different funds required to maintain enterprise equity, research and development, wages, and some social services. Remaining profits could be disposed of according to the preferences of the enterprise management. This was not novel; the radical change lay rather in the legal protection of such funds from arbitrary state appropriation. But again, state ability to control whether enterprises adhered to the Law was limited due to the reorganization of state bodies and reduction in the number of civil servants. Furthermore, the seemingly endless stream of new laws and regulations must have had a detrimental effect on their ability to take advantage of the access they had to monitor the enterprises.

State control of the enterprise involved the right to appoint and dismiss the manager. Yet this could only be done after consultation with the enterprise Supervisory Council, a unit introduced by the Law. The Council was to consist of representatives from the employees and the founding ministry in equal numbers. The Supervisory Council replaced the Worker's Council that had existed under planning.

The Law left little scope to the Supervisory Council. Despite the principle of parity being applied and the adjective "Supervisory", the actual rights of the employee delegation amounted to no more than being *heard* by the founder ministry and *recommending* changes in enterprise management. Apart from being empowered to review accounting statements and the allocation of profits and make its views known to the founding organ, its function was described as advisory. The Council could discuss strategies for the enterprise, but management was under no obligation to act in accordance with its conclusions. The ability of the Council to recommend changes was limited by its lack of insight into decisions taken at management board meetings. Legally, employee representatives had no automatic right to attend as had been the case under the KSC regime. Instead, the preferences and interests of management would be decisive when assigning employee representatives a seat.

If the Law had given the Council access to monitor management decisions closely, the ministerial appointees' resort to the possibility of dismissal would have been a potential danger management would have had to take into account. Being denied extensive monitoring rights, the threat of dismissal had little impact on management behavior. Furthermore, the Law failed to specify reasons for removal, although incompetence and corruption have been cited as valid. On the other hand, the Ministry could only act on the information supplied to the Supervisory Council, and apart from statements of accounts and the distribution of profits which were set according to fixed rules and therefore purportedly factual, enterprise management in practice decided what information should be made available to the Council.

Managerial response

The formal supremacy of the state as owner was undermined by asymmetry of knowledge between the newly created Ministry of Industry and the managerial strata. Enterprise management possessed detailed knowledge of the production capacity of their enterprise, a capacity which under the old system had been systematically underestimated when dealing with the central planners. Management would be able to identify the range of outmoded products manufactured with central financial support and therefore have a clearer idea of the portion of their output that stood the best chance of making a good profit. Although the Law had prohibited the division of the enterprises into new constituent parts, management was not denied the right to establish private firms or workshops. This possibility enabled them to single out the most lucrative assignments given to the state enterprise and transfer them to their own firm. Machinery and production equipment could be leased from the state enterprises, and since management would be the same in both firms, the lease would be fixed at an artificially low level. This policy also had an impact on the labour force. Often the most highly skilled workers would join the new firms envisaging that they would get better pay and more stimulating work tasks. The strict wage regulation imposed by the government did not apply to private firms with less than 25 employees. Thus, with the desire by the government to provide incentives for private enterprise as well as the uncertain future facing the state sector, powerful incentives for qualified workers to leave the state sector had emerged.

The extent and impact of this kind of private enterprise are impossible to assess with any accuracy. It was certainly widespread as an activity undertaken "on the side", evading fiscal duties and falling outside the framework of statistical registration¹⁶. Approximately three-quarters of those engaged in private economic activities by the end of 1992 retained their main occupation in the state sector¹⁷. When the government introduced compulsory social insurance regulation for private entrepreneurs in 1993, more than a third relinquished their private activities. The share of legally registered private entrepreneurs in industrial employment was a mere 8 per cent by the end of 1992¹⁸. These data showed that industry was relatively unaffected by the grass-roots privatization that went on in the economy as a whole. What is not mirrored in the statistics is the extent of internal resource reallocation between the different units of the state enterprises, strengthening a select number at the expense of others. This was a problem referred to in the press, but it was not until late 1993 that the full impact of this reallocation became evident. What was formally referred to as the "remnants" of the former state enterprises, and less formally "the living dead", had to be given considerable subsidies in 1993 in order to keep them afloat and make them saleable¹⁹. It is relevant to question whether this could have been prevented by the state. The state representatives at enterprise level had several enterprises in their portfolio. Further-

¹⁶ *Hospodářské noviny* 20 February 1992.

¹⁷ Serghyová, Jana: *Entrepreneurship in Central East Europe*. Heidelberg 1993, 39.

¹⁸ *Ibid.* 40.

¹⁹ *Hospodářské noviny* 6 October 1993.

more, the Law was declared to be a purely transitory measure and it was expected that the impending legislation on privatization would provide enterprise managers with new incentives as well as relieve the state of some responsibility for the enterprises. A close involvement could therefore easily prove futile and trigger accusations from management that state interference persisted despite the transition.

The Law on state enterprises being transitional, attention was focused on the impending privatization. Those sectors of industry where management had benefited from the Law resented what they regarded as attempts to cancel out conditions through new legislation. In the course of 1990, when state price controls and subsidies were still untouched, many enterprises had purchased considerable amounts of input materials. Upon the removal of price controls in 1991, they were able to reap profits despite falling demand. This brief period of grace ended rapidly, and many industrial managers had reason to fear bankruptcies would become a reality. The Union of Industry, a managerial organization embracing mainly the state sector, published a document in 1990 where this was reflected²⁰. In the precept, it was stated that the privatization process would be lengthy, and because it would be in the interest of the country to retain as much as possible in national hands, the transfer of property to private investors should be implemented gradually when private capital grew sufficiently to take over the enterprises. The first step should be the transfer of all state-owned enterprises to a national property agency administered by the government. This part of the recommendation did not differ from governmental plans then discussed in Parliament and the media. But the Union of Industry recommended to include on the board of the agency a sizeable share of delegates from the enterprises. Privatization should only be undertaken when the management of the firm deemed the firm ready, and the income generated through the sale should be returned to the firm. The documents were published with the intention of influencing the contents of the Law on large-scale privatization.

The initiative had been taken by management in heavy industry, a sector that had been targeted for reductions by many government economists even prior to 1989. Heavy industry enterprises were aware of their vulnerable position and had set up a joint enterprise called Iron Metallurgy (*Hutnictví železa*) to lobby the authorities. But because the mere name would discredit the initiative, the more neutral sounding Union of Industry, of which the Iron Metallurgy was a member, was chosen. The undertaking did not pay off in terms of government concessions, but it is notable in that it was an effort undertaken by management to influence the process collectively.

The Law on large-scale privatization

The transfer of state-owned property to new owners took place pursuant to three different sets of legislation according to the character and origins of the assets. One law

²⁰ Svaz průmyslu: Iniciativní materiál ke koncepci deetatizace a privatizace [Union of Industry: Initiatory Material on the Concepts De-etatization and Privatization]. Prague 1990.

regulated their restitution to former owners or their heirs²¹. It applied solely to property that had been confiscated subsequent to the Communist takeover in 1948. Large sections of industry, in particular heavy industry, was at that time already in state hands, and was therefore only marginally affected. Only in cases where former private enterprises had been transferred to state ones would property have to be restored. Small businesses, workshops, shops and service establishments were auctioned off at local level in accordance with the Law on small-scale privatization²².

The Law on large-scale privatization, i.e. affecting industrial enterprises, was passed by Parliament as Law no. 92/1991 entitled "On the conditions of transfer of state-owned property to other persons"²³. It was originally passed as a federal law, yet remained in force in the Czech Republic after the division of the country. Preceding its enactment, an extensive debate had taken place in Parliament over the speed and manner of privatization. For some time, the role of international economic organizations and foreign advisors incited contention. Members of the opposition claimed that the IMF and the World Bank exercised too great an influence on the reforms, resulting in recklessness and haste²⁴. Yet the debate petered out largely due to lack of any discernible difference in the reform concepts worked out by Klaus and the recommendations made by the IMF and the World Bank. There were occasions when the government referred to the conditions made by the IMF in order to get a budgetary measure through Parliament, but in the working out of the privatization, international advisors played no more than a secondary role. The approach chosen was portrayed by the government as "the Czech way"²⁵.

The number of Czech enterprises affected by the Law on large-scale privatization has been estimated at approx. 3600²⁶. They were to be realized in two sales waves, and according to the initial time schedule, the first was to be terminated by the end of 1991, and the second by late 1993. The final deadline was later extended to April 1994. The deadlines confirmed the determination to speed ownership change by the government.

Relying on the state bureaucracy to implement the ownership changes, the government feared a reactivation of the old informal network to the detriment of the reforms. Although the old ministerial structure had been altered, little staff turnover resulted.

²¹ Law no. 87/1990 "On Rehabilitation Out of Court" and Law no. 403/1990 "On the Mitigation of the Consequences of Some Torts Concerning Property". In the case of arable land, property confiscated as far back as 1944 can be restituted under the auspices of Law no. 229/1991 "On Changes of Ownership to Land and Other Agricultural Property".

²² Law no. 427/1990 "On the Transfer of State Ownership of Some Objects to Other Corporate Bodies and Natural Persons".

²³ Present discussion is based on the English translation of the full legal text with subsequent amendments, published under the title: Privatization in the Czech and Slovak Republics. Prague 1993.

²⁴ For an early and unbiased analysis see Procházká, Petr: Vliv mezinárodních měnových institucí na ekonomickou reformu v ČSFR [The Influence of International Monetary Institutions on the Economic Reform in the ČSFR]. Prague 1991.

²⁵ This was reflected in the title chosen for a collection of articles by the prime minister Klaus, Václav: Česká cesta [The Czech Way]. Prague 1994.

²⁶ Statistická ročenka České republiky '93. Prague 1993, table 19-2. p. 290.

At enterprise level, the managerial strata had survived 1989 virtually intact²⁷. At the same time, the ministries possessed considerable expertise concerning enterprises that had hitherto been in their portfolio, and this would have to be taken into account in the preparation of projects made prior to enterprise sale. As a result, the responsibility for compiling privatization projects for each enterprise lay with the founding ministry, meaning *inter alia* that almost all industry enterprises were part of the portfolio of the Ministry of Trade, Industry and Tourism (henceforth the Ministry). Yet the formal vetting of the projects would be undertaken by the newly created Ministry for the Administration of National Property and Its Privatization (henceforth MANPIP). The enterprises covered by the Law would, on the formation of a suitable privatization project, be transformed into joint stock companies, all shares being transferred to The Fund for National Property (henceforth the Fund) responsible for safeguarding ownership rights until new owners had purchased it.

Privatization projects

Although responsibility for the privatization projects lay officially with the Ministry, the sheer number of enterprises prevented the Ministry from playing an active part. Compiling the information required, and producing a basic privatization project for the enterprises was therefore transferred to enterprise management.

The Law stipulated that a privatization project should contain "economic, technical, proprietary, timetable and other data . . ." ²⁸. The economic data moreover was not complete without a record of enterprise liabilities and uncollected debts. Furthermore, uncollectible debts and unusable assets were also to be listed. Added up, the final sum was taken to indicate the so-called book value of the enterprise²⁹. The usage of the book-value as point of departure was fraught with problems since the data were based upon the institutions of a planned economy, and therefore of limited relevance under the new conditions. For instance the value of the industrial property had been based on state-set rates and did not reflect proximity to international borders or main arteries of communication. Enterprise earnings had been the result of state subsidies for raw materials and energy, and high prices for finished products. The fact that producers enjoyed a virtual monopoly on the domestic market also had a bearing on earnings. The main export market had been the Soviet Union or the former CMEA. Earnings here were influenced by state-set exchange rates. The data for the financial health of the enterprise were therefore of limited relevance. In particular the problem of

²⁷ There are no exact figures on exchange of management in the former state enterprises. Ivana Mazálková in her discussion of the role of management in the formation of industrial relations concludes that the legacy of past authoritarian managerial practice has remained unaffected see Mazálková, Ivana: *Role managementu při formování pracovních vztahů v privatizovaných podnicích* [The Role of Management in the Formation of Labour Relations in the Privatized Enterprises]. *Sociologický časopis* 3 (1994) 361–372.

²⁸ Law no. 92/1991. Section 6.

²⁹ Šafaříková, Vlasta et al.: *Velká privatizace aneb Průvodce privatizačním projektem* [Large-scale Privatization or Guide to the Privatization Project]. Prague 1991. In particular the chapter entitled: *Oceňování majetku* 39–42.

inter-enterprise indebtedness, i. e. financial obligation to other enterprises not honoured when falling due, illustrates this. By December 1989 the aggregate sums for Czech enterprises amounted to 6.2 billion Crowns³⁰, increasing rapidly in the course of 1991 when the projects were compiled, ending at 113.2 billion Crowns, to grow at a slower pace in the course of the next two years³¹.

What favored using book-value was the fact that it would enable a relatively fast evaluation based on common measures of all the assets. The Law opened for the use of external experts, but this was done only in a select number of large-scale enterprises where foreign bidders could be expected.

A central point in the project was to provide a privatization recommendation: "... the method for the distribution of shares, their allotment (ownership interests) and possibly also the types of shares, as well as information about whether, and to what extent investment vouchers will be used"³².

Although management was legally obliged to produce a project to be presented to the Ministry, anybody was at liberty to produce competing projects. The Law required management to supply the authors of competing projects with all the information they requested. The decision to introduce competition at this stage was motivated out of suspicion that management would bias the projects to serve its own needs. Opening up for competing projects proved a success at least in numbers. The number of privatization projects exceeded 16.000, more than four times the total number of enterprises³³. But in some cases, management sent in several projects, and in others they have flooded the Ministry with recommendations for reevaluations, new data, etc.³⁴.

Ministerial capacity to compare and assess the pros and cons of each project was very limited, the number of ministerial employees being in the range of 500³⁵. Their ability to select the most suitable project was further hampered by the apparent lack of any criteria upon which to base their selection, something that was indeed admitted by an advisor in the Ministry of Industry: "Everything is completely ad hoc because there are so many variables and combinations of factors"³⁶.

The lack of clear-cut guidelines was further complicated by the extreme time pressure under which the Ministry was operating. For enterprises included in the first privatization wave, projects had to be presented to the Ministry by 31 October 1991, i. e. seven months after the Law was passed by Parliament. The Ministry was then given one month to assemble and evaluate the projects before transferring them to MANPIP. In the second wave, the number of enterprises was larger, the Ministry then

³⁰ Hrnčíř, Miroslav: Monetary and Credit Policies for Transition to a Market Economy. Prague Economic Papers 2 (1992) 109–125, here 122.

³¹ Dyba, Karel/Švejnar, Jan: An Overview of Recent Economic Development in the Czech Republic. Prague 1994, 14.

³² Ibid.

³³ Statistická ročenka České republiky '93. Prague 1993, 290, table 19–2.

³⁴ Buchtíková, Alena/Čapek, Aleš/Macourková, Eva: Statistical Analysis of the Privatization Projects. Prague 1992, 16.

³⁵ Olsson: Vad är en voucher? 34. – Sereghyová: Entrepreneurship in Central East Europe 35.

³⁶ Ibid.

having two months at their disposal before sending them on to MANPIP³⁷. However, every step of the privatization process turned out to take much longer than initially planned, and the deadlines were therefore repeatedly broken and extended. Nevertheless, the emphasis on speed and the resultant inability of the ministerial staff to survey each project properly did not change³⁸.

If the Ministry failed to reach a conclusion, the competing projects would be transferred to MANPIP for a final decision. The ability of the latter to reach a verdict, or even to revise other projects suggested they also were constrained by the lack of skilled personnel, the staff counting no more than approx. 160³⁹. The position of MANPIP later in the privatization process was relegated, when all the ministries were given the possibility of passing a final verdict over competing projects⁴⁰.

Yet this did not mean that any attempts were made to single out industrial sectors that were less monopolized, or sectors with better prospects for survival than others. If the aim of removing direct state ownership had been to increase economic efficiency, a more selective strategy could have been applied. Service and light industries had clearly better growth prospects than others. The smaller unit size of the enterprises/workshops further meant that adapting behavior to meet the market would require less time and resources than in the case of heavy industry. Yet based on the statements made by Klaus where he said clearly that it would be the task of new owners to undertake restructuring of the enterprises, it is not surprising that no strategy selectively sequencing industrial sectors and firms for privatization was applied. At the time of drawing up the privatization projects, some analysts concluded that the approach "would have minor (if any) improvements in overall efficiency and welfare and thus [lead] to great dissatisfaction as concerns the outcome of the privatization process."⁴¹

Although this conclusion was based on sound reasoning when made in 1992, it presupposed that the termination of direct state ownership would mean a shift from the policy of soft budget constraints to a market economy where budget constraints would be hard, and bankruptcy a real threat.

The formal institutional changes outlined above left enterprise management with new possibilities to strengthen its position. The persistence of past patterns is arresting given the fact that the centre was obliged to rely on the enterprises to compile the information necessary for implementing political aims. The difference was of course the fast changing institutional arrangements, removing on the one hand many of the monitoring functions that had been ingrained in the former bureaucracy, on the other severely limiting predictability and thus the time horizon for managerial strategies.

³⁷ Charap, Joshua/Dyba, Karel/Kupka, Martin: *The Reform Process in Czechoslovakia: An Assessment of Recent Developments and Prospects for the Future*. *Communist Economies and Economic Transformation* 1 (1992) 3-22.

³⁸ Klvačová, Eva: *Kritickou rychlost privatizace nesmíme překročit, říká Ministr Jiří Skalický* [We should not exceed the critical privatization speed, says Minister Jiří Skalický]. *Ekonom* 15 (1993) 15-17.

³⁹ Olsson: *Vad är en voucher?* 34.

⁴⁰ *Prager Zeitung* no. 5, 1994.

⁴¹ Buchtíková et. al: *Statistical Analysis of the Privatization Projects* 11.

When recommending a suitable key for the privatization, management could opt for the widest possible dispersion of new owners, rendering consolidated efforts to press management for changes less likely than would be the case with a single purchaser or few shareholders. The ability of the state to prevent managerial interests from winning was in fact limited. Management could exert influence over ministerial vetting of privatization projects in several ways. Supplying information to outside project designers could be delayed, or alternatively management would provide competitors with fragmented or even faulty information. Theoretically this could be remedied through complaints to MANPIP. Although the Law allowed for court proceedings against reluctant management, this was regarded as a theoretical option by most since the courts were overloaded with cases and proceedings impossible to handle within the deadlines given for the compilation and vetting of the projects. As a consequence, competing projects often contained insufficient information, and were therefore rejected.

A further reason for MANPIP to favor basic projects was that these more often embraced the entire enterprise, whereas competing projects tended to embrace only a constituent unit. Granting its approval to a basic project would save considerable time for MANPIP, the alternative being several projects that were not internally compatible. Therefore, despite the impressive number of privatization projects sent to MANPIP, the result was a clear preference for projects designed by management during the first privatization wave⁴². The percentage of management-sponsored projects of approved projects was above 80 in the case of heavy industry, more than 70 for light industry. However, the proportion of basic projects in the fuel and energy sector was much lower, only 59 per cent. The government may conceivably have wished to take advantage of privatization to split the strong fuel and energy lobby. The links between this sector and heavy industry were traditionally close; under planning they had been able to exert strong pressure on the centre for preferential treatment. Once the monopoly position in the fuel and energy sector was broken through privatization, joint actions with heavy industry would be less likely, and the latter would be subject to stronger pressure for change than would otherwise have been the case. That being the reason for the different ratios, would imply that the government was not beyond employing the privatization process as a discriminatory instrument⁴³.

An alternative explanation, attributing less to governmental industrial policy, concerns the involvement of local government in the competing projects for the fuel and energy sector, in particular concerning the fate of the electricity works and heating plants. Local government would succeed in obtaining financial guarantees more easily than management⁴⁴. Moreover, it should also be added that collecting information on coal mine operation is a far easier task than for instance that on a heavy industry enterprise,

⁴² Comparable statistics for the second privatization wave not available at the time of writing.

⁴³ That is also the explanation hinted at by Buchtíková et al.: *Statistical Analysis of the Privatization*.

⁴⁴ Lukavská, Lenka: *Energetická politika, vysoké napětí [Energy Policy, High Voltage]*. *Ekonom* 49 (1993) 21–23.

where the informational asymmetry between management and anyone on the outside with ambitions to launch a competing project often proved too wide a gap to cross.

If the government had wanted to ensure that the basic projects focused on adaption to the market and profitability, this could have been achieved by tying management interests to enterprise earnings by granting them property rights in the form of shares. Enterprise management and the trade unions alike favored employee share-ownership schemes. It had been the subject of a major dispute during the small privatization. The argument used by the trade unions was that if the principle of justice was so important to the government that it allowed restitution to be completed prior to privatization, then the principle should prevail and be open for shares to be transferred to employees. That would transform the mock public ownership of the past into genuine ownership. Yet, since it was obvious that many of the former employees lacked sufficient means to purchase outright the property in question, the trade unions demanded they should be given favorable low-interest loans to enable them to purchase the properties. At a closed meeting of all three governments (Czech, Slovak and Federal) in 1990, the ministers responsible for the economic transition were close to being outvoted on the issue by the non-economic ministers favoring employees' closed round auctions prior to open bidding⁴⁵. The economic ministers insisted that the first round of the auctions should be open to all Czechoslovak citizens on equal terms, only opening up for foreign bidders in the second round. A compromise was reached in Parliament permitting enterprises to transfer up to 5 per cent of their shares to the employees (in the case of smaller firms, a maximum of 10 per cent was permitted), but only on condition the enterprise covered the costs of the shares. Furthermore, the shares were to be sold at their book value, i.e. at a higher price than the shares could expect to gain in the privatization rounds. Apart from the fact that few firms possessed the capital required, the price of shares proved an efficient deterrent. Therefore, employee ownership has remained marginal⁴⁶.

To many representatives to the left of the government, the suggested scheme was not preferential enough, while others disapproved because it smacked of the old regime's discriminatory practices favoring one group over another. The argument that ownership shares would be a just remuneration to those who had worked in the enterprise was rejected by Klaus, voicing concern for a just treatment also for the multitudes that worked in the health and educational sectors. Their place of employment would remain in public ownership. Any concession to those working in industry would leave those in public sector relatively worse off. The argument was a strong one in so far as the salary level was appreciably lower than in industry.

Losing the battle over employee shares has not prevented the trade unions from attempting to influence the drawing up of privatization projects by management. In some of the cases, where management has refused to negotiate with the trade unions, local strikes have resulted. In 1992, when privatization plans for the brewery

⁴⁵ Information supplied by Mr. Igor Pleskot, Member of the Presidium of the Czechoslovak Metalworkers' Federation, Prague 1992.

⁴⁶ Divíla, Emil: *Vlastnická participace zaměstnanců* [Ownership Participation of Employees], *Politická Ekonomie* 2 (1993) 211–222.

Plzeňský pivovar were drawn up, the trade unions went out on strike to protest against what they claimed was the sell-out to foreigners of national heirlooms. Yet, the trade union concerned failed to gain any concessions whatever from the MANPIP or the management. Nevertheless, judging from press reports there have been more cases where management and labor would join forces and press the centre for lump sum transfers at times of financial difficulties. In particular the largest heavy industry enterprises, like ČKD Praha, Škoda Plzeň, and Poldi Kladno, management and labor have pursued this policy with success also after 1989⁴⁷. Light industry enterprises on the other hand have never been known to achieve similar treatment.

More frequent, however, has been disagreement between local trade unions and enterprise management over the question of redundancies. The central trade union leadership has supported governmental statements conceding that over-employment is a real problem making redundancies unavoidable. Local trade unions would hold a different opinion, emphasizing instead the need to reduce clerical staff as part of enterprise strategy. How strongly they would push management for sustaining employment would depend on internal enterprise relations and managerial perception of what could be gained from an alliance. What is clear is that public awareness or fear of unemployment remained low in 1991–92 when the projects were made⁴⁸. The trade unions could not singlehandedly influence the compilation of privatization projects, but were dependent upon managerial goodwill and need to include them. Thus, management could tailor the projects according to their aims. This meant that the privatization key suggested by management prevailed. Above all this meant a larger proportion of shares set aside for voucher privatization than suggested by competing privatization projects⁴⁹. Since the economic motives were of secondary significance, income from the sale of shares being transferred to the Fund, the most likely explanation is managerial desire to disperse ownership, making any joint efforts by shareholders difficult.

Privatization projects and enterprise strategies

Early in 1993, the economic newspaper *Hospodářské noviny* complained that enterprises hung as in a limbo without any strategies for development⁵⁰. Blame was put on management. Apart from rendering factual information about the enterprise, and suggesting a privatization key to suit it, management was also required to produce a strategy for the enterprise. These strategies display certain common features that should be mentioned since they illustrate the influence of comprehensive institutional

⁴⁷ For ČKD Praha and Škoda Plzeň, see A d á m k o v á, Alena: Bez radikálního řezu to nepůjde [It won't work without a radical break]. *Ekonom* 42 (1992) 35–37. – On Poldi Kladno: *Hospodářské noviny* 11 February, and 8 December 1993.

⁴⁸ Low public awareness of unemployment is reflected in the opinion polls presented by Večerník, Jiří: Trh práce: problémy a perspektivy [The Labor Market: Problems and Perspectives]. *Sociologický časopis* 3 (1992) 319–336.

⁴⁹ This assertion is statistically proved by B u c h t í k o v á: Statistical Analysis of the Privatization Projects.

⁵⁰ *Hospodářské noviny* 20 April 1993.

change on managerial ability to plan, but also because the strategies suggested will have a bearing on Czech economic development.

Under planning, it had been in the interest of enterprise management to underestimate the production capacity and skills in order to avoid an increase in centrally set demands. This behavior persisted in a tendency for management to underestimate the development potential of the enterprise when drawing up a privatization project⁵¹. Even Czech enterprises that were able to produce certain items more cheaply than corresponding Western imported products, often refrained from stating this in the privatization projects, tending rather to down-grade the potentials of the enterprise and draw up plans for the production of less sophisticated goods. Whereas the original output could have been very competitive due to the low labor costs in the Czech Republic, the latter alternative means that Czech products must compete with Third World products, thus losing their competitive advantage based on low labor costs⁵².

The ability to choose a privatization project or a cooperative relationship with an investor, be it foreign or domestic, was further constrained by behavioral patterns established during the Communist period. Before 1989, the ability to solve a task was always estimated in terms of having the necessary raw material and labor at one's disposal. Expertise and skills were rarely given any attention at all, the non-fulfilment of a plan target being explained in terms of sudden and unexpected bottlenecks in the supply system. This behavior has persisted in the belief that any enterprise whatsoever will be able to perform a given task given the availability of the means necessary; i. e. chiefly capital. This pattern is complicated by the fact that some enterprises were clearly in need of financial transfers from the central authorities to tide them over a difficult period, whereas others were not. However, the government lacked the institutional apparatus required to vet the requests and see whether the plans corresponded to the production potential. The result was that many enterprises drew up privatization projects where the actual production capacity and skills were analyzed as being capable of flourishing only given massive investment.

Closely related to this misconception is another that also has its origins in the past, the belief that production of finished goods is the sole indicator of a sophisticated technological level. This misconception led to the refusal by management to become a supplier of semi-finished products to Western or domestic enterprises, despite the fact that such production is also dependent upon advanced techniques and high levels of skill. This attitude has been nourished by the policy of many foreign investors, who desired to concentrate on the manufacturing of simple products or raw materials. This development was mirrored in the foreign trade statistics. Overall exports have showed an impressive growth since 1991, but the relative share of raw materials and chemicals has increased at the expense of manufactured products⁵³. Unless this trend is re-

⁵¹ For a discussion of the dismal turn with respect to manufacturing of sophisticated goods, see Pape, Markus: *Deindustrialisierung schon im vollen Gang*. Prager Zeitung no. 23, 1993.

⁵² Sereghyová: *Entrepreneurship in Central East Europe* 181.

⁵³ *Statistická ročenka České republiky '93*. 274 table 18–4. Figures for 1994 showing a continued decrease in manufactured products although with an improvement for some consumer goods, are found in: *Czech Economic Monitor*. PlanEcon Report 16 January 1995, 27–37.

versed, the Czech Republic will remain a supplier of labor- and energy-intensive, often highly polluting products to the more advanced West.

The Fund for National Property as owner

When a project had been agreed upon, the enterprise was thereupon transformed into a joint stock company and transferred to the Fund. The Fund now became the sole owner of the shares of the enterprise pending privatization. The Law failed, however, to specify to what extent the property rights entailed responsibility for restructuring the enterprise to meet the requirements of the market. Such an acknowledgment would have contradicted the political tenets of the government, and would furthermore have led to considerable costs for the state, thus creating a potential drain on the state budget and endanger the attempts to retain budgetary balance and keep inflation under control. That threat was not disputed, and apart from the odd statements made by the Social Democrats, nobody openly favored upholding state subsidization. The debate focused instead on future use of Fund assets; since these were prevented by law from being transferred to the state budget, a sensible option would be to consign the holdings back to the enterprise sphere. But also on this point, the law was ambiguous, section 12, point 4 reading: "The property in the Fund may be used to meet the obligations of the enterprises designated for privatization"⁵⁴. This was understood to cover sales expenses, e.g. information brochures, pamphlets, holding of auctions, negotiating with potential bidders, etc. But what the "may be used" implied beyond marketing needs and restitution claims remained a subject of dispute since the Law failed to specify in what cases allocation of capital from the Fund would be permissible. In 1991, when the first scholarly discussions of the law were published, this clause was interpreted liberally to mean coverage of enterprise debts: "to enable enterprises undergoing privatization to fulfil their contracts"⁵⁵.

Pledges had been made by Fund representatives that it would only support financially those enterprises that had a chance of being profitable. Yet what criteria that would be used to establish potential profitability were not elaborated. Furthermore, the alternative to Fund support would have been closure, and that was unlikely for two reasons. First, if the Fund bankrupted an enterprise, the creditors would address their claims for financial compensation to the Fund. That had been the outcome of the few cases where the Ministry of Industry had liquidated industrial enterprises. Second, the option was legally difficult to implement since enterprises undergoing privatization were protected from bankruptcy proceedings⁵⁶. Therefore, the Fund was forced to supply the enterprises ad hoc with capital to keep them afloat in the

⁵⁴ Law no. 92/1991. Section 12, point 4.

⁵⁵ Interpretation of Law no. 92/1991 provided by Plív a, Stanislav: *Privatizace majetku státu* [The Privatization of State Property]. Prague 1991, 131.

⁵⁶ Law no. 328/1991: The Bankruptcy and Composition Act. Section 67: Bankruptcy and Privatization. Prague 1993, 63–66.

period before the new owners were ready to take over. By the end of 1993, this tapped the Fund for almost 24 billion Crowns, or almost half its capital⁵⁷.

In some cases the financial straits were caused by foreign firms defaulting on their payments. The foreign firms, often in the former Soviet Union or in the Third World, had imported Czech goods under state trade agreements signed by the former Communist regime. The enterprises expected the government to aid them in retrieving the outstanding sums. The issue of the unpaid foreign debts remained on the agenda in the bilateral relations between the Czech Republic and Russia until spring 1994⁵⁸.

A more important problem was posed by the emphasis on speed and the time required to check the creditworthiness of new owners. This was highlighted when the head of the Fund for National Property, Tomáš Ježek, resigned from his position in June 1994. According to the official explanation made by the Minister of Privatization, Jiří Skaličský, three intertwined problems had emerged that the Fund's chairman and board had been unable to solve⁵⁹. Firstly, the Fund had accumulated considerable debts from the sale of enterprises to investors who defaulted on payment. Secondly, too much time passed before the sales were executed, the Fund retaining the assets longer than thought necessary by MANPIP. Thirdly, Fund representatives on enterprise boards had failed to represent the property rights of the state⁶⁰. Since the Law was notoriously vague on these aspects, a more likely conclusion is to interpret the official reasons given for Ježek's demise served as cover-up for political disagreement. But whether the change of leadership should be interpreted as the start of a new Fund policy of spending more efforts to vet buyers is too early to say. In August 1994, the new head of the Fund, Roman Češka, interfered personally in the case of Poldi Kladno and sacked the new owners for defaulting on payments to the Fund. The Fund together with MANPIP appointed new members of the enterprise board, thus reintroducing Fund ownership pending take-over by new owners⁶¹. However, this was apparently an exceptional move, serving as a warning to potential bidders that the Fund might rescind transfer of assets. Still, no formal steps were taken to clarify the Fund's role as owner, or indeed set a definite deadline for when the organization would be dissolved. Everything was stated to be dependent on swift transfer from the Fund to new owners.

Transfer to new owners

The book value of the industrial enterprises transferred to the Fund grossly exceeded the savings of the population. Foreign investors could only be expected to purchase certain well-known enterprises. But even in these cases, public debate reflected the animosity that sometimes had been voiced over the role played by the IMF and the

⁵⁷ Brom, Karla/Orenstein, Mitchell: *The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy*. *Europe-Asia Studies* 6 (1994) 893–928, 900. Statistical source not quoted.

⁵⁸ *Hospodářské noviny* 6 April 1994.

⁵⁹ *Prager Zeitung* no. 26, 1994.

⁶⁰ *Prager Zeitung* no. 30, 1994.

⁶¹ *The Prague Post* 1 March 1995.

World Bank. The fact that most foreign investors were German refuelled historical resentment⁶².

The debate over restitution had revealed resentment to what was perceived as the return of the former elite to "take away the choicest bits"⁶³. A feeling of disillusionment over property changes seemed to have been widespread in the population, most people expecting declining living standards to persist in the foreseeable future. In opinion polls taken in 1991 and 1992, the share of the population preferring a "democratic socialist system, as seen in some Western societies" amounted to 35 per cent, a portion equalling those in favor of continued reforms⁶⁴. This state of affairs threatened the government's strategy. If the majority of the population proved to be alienated by the reforms, an alternative strategy with a more gradual approach would have to be applied. That would inevitably mean the defeat of the governmental approach to the transition and the opposition would stand to gain in the upcoming parliamentary elections in June 1992. Thus, both the lack of domestic capital as well as the desire to attract popular interest were powerful incentives for the application of non-traditional approaches. Selling state enterprises to the citizens at an affordable price would combine the need to attract popular support and involvement with the necessity to ensure a swift transfer of property rights. Although this would imply selling the enterprises at less than book value, it was argued that it would be a remedy for the torts suffered under the previous regime. This could be done by distributing investment vouchers to the population at a nominal fee. The price was set at 1035 Crowns, an average week's pay. The booklets were sold at the post offices, and could be bought by all citizens over 18 years. The Federal government passed a decree on investment vouchers on September 5, 1991, assigning the printing of vouchers booklets and investment stamps to the Federal Ministry of Finance⁶⁵. Holders were then at liberty to bid for any enterprise by assigning some or all of their shares to vouchers.

In the first wave of privatization, 988 firms offered some of their shares for purchase by voucher, most combining direct sale to a single bidder with vouchers as payment mode⁶⁶. But almost 40 per cent of the enterprises were to be privatized exclusively through vouchers⁶⁷. Initially, there was little interest among the population to participate in the voucher privatization, and opposition politicians interpreted this as a rejection of the entire reform package. It was even expected that the voucher privatization would be terminated after the 1991 elections when little more than half a million Czechoslovaks had registered. The government had reckoned with some 4 million purchasing investment booklets out of a total of 11.5 million eligible persons.

When the period of registration expired in February 1992, almost 8.3 million out of

⁶² Die Presse 25 September 1990. – Holub, Petr: Český průmysl do českých rukou [Czech Industry in Czech Hands]. Respekt 1, November 1993.

⁶³ Rudé právo 10 June 1991.

⁶⁴ Matějů, Petr/Řeháková, Blanka: Od nespravedlivé rovnosti k spravedlivé nerovnosti? [From unjust equality to just inequality?]. Sociologický časopis 3 (1992) 293–315, 314.

⁶⁵ Hospodářské noviny 10 September 1991.

⁶⁶ See Kotrba, Josef/Švejnar, Jan: Rapid and Multifaceted Privatization: Experience of the Czech and Slovak Republics. Prague 1993, 31.

⁶⁷ Ibid.

11.5. eligible persons had bought a booklet and had their investments registered. The upswing in vouchers sale could be explained by the emergence of investment funds toward the end of 1991. These invited booklet holders to submit their vouchers, and the investment funds would undertake the task of finding promising enterprises. All in all, more than 70 per cent of the voucher holders availed themselves of the funds⁶⁸. Some funds managed to attract considerable numbers of voucher holders by promising them a ten fold return within a few years. This calculation was based on the relationship between the initially meagre interest for voucher booklets and the book value of the enterprises. Thus no fund has been able to fulfil these pledges.

Whereas all changes in ownership status of the enterprises had formerly been prepared by the government and introduced as parliamentary acts, the investment funds emerged without any prior legislation regulating their function. In fact the first laws on their role and function only appeared in late April 1992, the point in time when the funds had received investment points, and immediately prior to the first rounds⁶⁹. Throughout 1991 only a very rudimentary set of criteria and rules that had been drawn up by the Ministry of Finance and issued as government decrees existed. Here it was specified that a down payment of 100 000 Crowns was required for an investment fund to be registered. The emergence of investment funds was perceived as countering the dissipation of shares, enabling more efficient execution of property rights than was practically possible for the individual shareholders. In the course of 1991, more than 400 funds had been established, signalling that the desired concentration of shares in a limited number of funds was in jeopardy⁷⁰. Yet despite the multitude, the 13 largest funds received almost 60 per cent of total investment points. On the other hand, as many as 313 were reported to have less than 10 million investment points each. That number was falling far short of the required amount to ensure profitability, let alone enable the funds to exert any pressure on management to restructure⁷¹.

Though such minor funds turned out to have too many unprofitable enterprises in their portfolio, they could not be declared bankrupt. During 1991 and 1992, the politicians confirmed the need for a bankruptcy law which would ensure closure of enterprises and funds alike that were obviously unviable, yet implementation of the law was postponed twice. Closing down funds would undermine public support for the reforms. As an alternative to bankruptcy, it was instead decided to limit the growth of funds by raising the required down payment from 100.000 to 1 million Crowns as from 1 January 1992. Furthermore, to reduce vulnerability to future enterprise bankruptcies, a fund was obliged to disperse its shares between at least ten enterprises, holding maximum 20 per cent of the shares in a single enterprise. Some funds circumvented this by splitting up into several new investment funds⁷². It was therefore decided that funds with the same owner could not own more than 40 per cent of the shares in one enterprise.

⁶⁸ Wendelowa, Petra (Managing Director of the investment fund Harvard Stock Exchange Company Inc.): *Privatization Funds as New Owners of Privatized Enterprises*. Prague 1993, 2.

⁶⁹ Law no. 248/1192, "Investment Companies and Investment Funds Act".

⁷⁰ Wendelowa: *Privatization Funds as New Owners of Privatized Enterprises* 2.

⁷¹ *Hospodářské noviny* 22 May 1992.

⁷² According to Wendelowa, Harvard Capital Consulting set up 20 affiliated companies during 1991 and 1992. Wendelowa: *Privatization Funds as New Owners of Privatized Enterprises* 3.

There was no unanimous response by the funds to the legal limitations. Numerous reports have appeared in the press showing that most funds have felt free to flout the regulations⁷³. Even when the funds were fined, they had the right to make an appeal to the courts. Nor are they obliged to surrender the shares but can retain them and reap the profits pending final judgment. Court trials being notoriously lengthy, the threat of legal action was no deterrent.

More worrying has been the number of enterprises in some fund's portfolios. A few funds have limited their portfolio to about 50 enterprises⁷⁴. But most have bought shares haphazardly with no preconceived plan in some cases funds are holding shares from more than 1000. The ability of the funds to make strategic purchases was ab initio influenced by the auctioning procedures undertaken by the Fund of National Property. The basic idea was that voucher privatization, combined with other methods, would simulate the market. The equation of supply and demand would result in a price expressing the real market value of the enterprise. Yet, the voucher privatization differed in two important ways, influencing the ability of the investment funds to make strategic purchases⁷⁵:

First of all, investment funds allocating their vouchers to stocks that got fewer points than expressed in their book value, received their shares immediately. That meant investment funds would be hesitant to invest if they expected interest to be low. If not, they risked being stuck with their shares, whereas others would secure them at a far lower price, the procedure being that unsold shares from the first round would be put up at a lower price in the next.

Secondly, the decision to speed up privatization meant that the bidding rounds were finite. Consequently, investment companies bidding for the most popular shares would receive none in the first round if supply proved to be significantly lower than demand. If the price was increased in the next round it was an important signal to other investors that these firms must have superior prospects among those offered. But again, the final price might not correspond to the actual market value of the enterprise, and thus finally frustrate the investors.

Perhaps the most important deficiency here was the fact that no decision was made as to how many rounds should be undertaken before an enterprise was fully privatized. This would have been a simple matter by means of setting a limit on the number of shares investment funds may purchase, e.g. when 90 per cent of the shares allocated for voucher privatization were sold, no more rounds would be undertaken. Instead, shares not sold in the first wave were transferred to the second. This has not only prolonged the sales of enterprise shares beyond the dates set in the initial plans, but also limited the ability of management to draw up any plans for the development of the enterprises, since this would depend on the approval of the new owners.

⁷³ The Prague Post 7 December 1994.

⁷⁴ Wendelowa: Privatization Funds as New Owners of Privatized Enterprises 3.

⁷⁵ The two main differences are based on the discussion of the voucher privatization by Bradá, Josef: The Mechanics of the Voucher Plan in Czechoslovakia. RFE/RL Research Report 17 (1992) 42-45.

The investment funds as owners

The deficiencies of the bidding procedures meant that the ability of the funds to make strategic purchase was limited, most ending up with shares from a wide range of different enterprises when the waves were completed. Although the subsequent trade in shares has resulted in a more homogeneous portfolio, the funds still faced problems in developing a strategy and implementing it at enterprise level. Not only the sheer number of enterprises meant that the monitoring ability would be restricted, but a further problem was posed by the legal regulation of enterprise boards failing to specify where ownership interests should be represented. The management board, the supreme enterprise organ making the day-to-day decisions, became the focus for contention.

The Commercial Code permitted the members of the management board to be elected either by the so-called general meeting consisting of shareholders, or by the supervisory council⁷⁶. In the latter case, funds could be outvoted by other groups and thus be denied a seat on management boards. In the debate following the enactment of the Commercial Code, managerial groups clearly opted for this solution, excluding shareholders from management boards. In the cases where enterprises established investment funds that subsequently bought shares in their mother companies, management tried to confine shareholder representation on management boards to their own funds⁷⁷. However, the banks were able to use credit conditions as a tool to get their funds represented. Thus the largest investment funds have gained a majority of the management board seats reserved for shareholders. Smaller funds, let alone individual shareholders, usually fail to gain any. In particular, in enterprises with good profit outlooks, the funds are represented on management boards, often outnumbering managerial representatives⁷⁸. In enterprises that have been rated as less profitable, the funds devote less resources and are represented on the supervisory boards. This indicates that the funds are able to make priorities and look upon their ownership as a long-term commitment. The fears that the funds would "milk" the enterprises failed to materialize. This can be explained when focusing on the ownership of the largest investment funds.

The owners of the investment funds

Of the ten largest investment funds, only Harvard Capital and Consulting was established by an independent entrepreneur. The rest were founded by banks. These were former state banks that had in the course of reforms been made independent of the National Bank. It was expected that private banks would be established and parti-

⁷⁶ Law no. 513/1991 "The Commercial Code". Chapter 2, Part 1, § 184–§201. The English translation of the text has been published under the title: *The Commercial Code*. Prague 1992.

⁷⁷ Mladá fronta Dnes 28 June 1993, quoted in Brom/Orenstein: *The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy* 911.

⁷⁸ This was asserted by Wendelowa: *Privatization Funds as New Owners of Privatized Enterprises*. And has been confirmed by the empirical material provided by Brom/Orenstein: *The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy* 920–925.

cipate both in the establishment of funds and in the purchase of shares. Though more than 40 private banks were set up, they were clearly dwarfed by the size of the four former state banks⁷⁹. By 1993, the newcomers had captured no more than 10 per cent of the market in loans and deposits⁸⁰. At the time transition commenced, all but a few of the bank clients were state enterprises. Though the proportion gradually fell somewhat in the course of 1992, the largest creditor bank, The Bank of Commerce, still had 97 per cent of its loans tied to the state sector⁸¹.

Bank ownership of the investment funds was initially not regarded with apprehension. But when it became evident that these funds purchased shares in their own funding banks, the lack of legislation preventing such behavior was openly acknowledged⁸². The other group of investment funds purchasing bank shares comprised funds set up by enterprises. These, mainly smaller funds bought shares in the banks to which their founders were indebted.

The de facto concentration of shares in bank funds should permit a more coordinated behavior by the owners. If ownership interests were split between investment funds with widely differing backgrounds, a conflict between those opting for a quick return on their shares and others advocating more long-term perspectives would have been likely. The dominance of the banks should permit the latter view to prevail. Nevertheless, the intimacy between the banks and the funds would also mean that the banks will tailor their interest rate and credit policy to the needs of their enterprises, even though the long-term perspectives might be negative. Thus insolvent enterprises would stand a fair chance of receiving bank credits to "bridge" them over in dire straits as well as to negotiate easier terms than private entrepreneurs starting from scratch would receive.

To what extent investment fund representatives are advocating the views of the banks is impossible to assert but highly likely, in so far as no measures have been taken to prevent any insider trading of information between the funds and the banks. In many investment funds a number of people simultaneously hold positions in local banks in the ministerial sector, enabling them, thanks to their special knowledge, to undertake a redistribution of wealth certain to benefit their clients. Part of this problem has been ascribed to the lack of qualified staff⁸³. In the course of transition, more people achieve adequate qualifications and the vacant positions can be filled. But still there has been a marked reluctance by government to take any decisive measures to counteract conflict of interests. After several political scandals, the most notorious being a fund-

⁷⁹ For a discussion, see V e n c o v s k ý, František: Diskriminace soukromých bank [Discrimination of Private Banks]. *Ekonom* 43 (1992).

⁸⁰ Privatization of Czech Banks. Ed. by Miroslav K e r o u š, Prague 1993, 2.

⁸¹ Calculations based on statistics provided by K l v a č o v á, Eva/V a n d u r k o v á, Naděžda: Komu banky půjčují? [Who are the Banks' Borrowers?]. *Ekonom* 37 (1992) 22–23.

⁸² *Ibid* 12.

⁸³ For a discussion of this problem, see P e l i k á n, Pavel: The Dynamics of Economic Systems, or How to Transform a failed Socialist Economy. In: On the Theory and Policy of Systemic Change. Ed. by Hans-Jürgen W a g e n e r. Heidelberg 1993, 67–95. – For complaints about the lack of educated staff, see U r b a n, Jan: Budeme mít trh manažerů [Will we have a market of managers?]. *Ekonom* 45 (1992) 41.

raising dinner hosted by the government party with many large state-owned enterprises paying the hefty entrance fee, minor legal amendments were suggested by the government in early 1995⁸⁴. Enterprises where the state holds a majority of shares or which receive state subsidies will be banned from making donations to political parties⁸⁵. Politicians will no longer be permitted to sit on management boards, and all extra income or gifts must be reported. These measures do not extend to spouses of politicians⁸⁶, nor do they solve the problem of informal exchange of information between the funds, the banks and the enterprises resulting from the widespread cross ownership.

Presenting the problems of enterprise ownership as limited to the role of the banks disguises the position held by the state. This is evident when focusing not on the funds, but on the ownership of banks. Changes in the formal ownership of the banks shares did not deviate from those of the enterprise sector: i.e. they were transformed into joint stock companies with all the shares in the possession of the Fund of National Property. The bank shares were offered for sale in the course of the two privatization waves, but government spokesmen declared that the state would retain control over between 40 and 50 per cent of the basic capital for at least a decade⁸⁷. The only other major group of shareholders was composed of the investment funds. Taking into account that virtually all had been set up either by the banks or by the enterprises, cross ownership may appear more confusing than it really is. The strongest shareholder in the case of the financial sector remains the state through the Fund for National Property. Whereas Fund ownership in the enterprise sector may be the undesirable outcome of lack of purchaser Fund ownership in the banking sector is not accidental. The government seems to be interested in continued state ownership in the banking sector. The statement by Privatization Minister Jiří Skalický in January 1995 that the privatization of the banks was only under discussion in the government, and therefore not imminent, supports this⁸⁸. He tried to underplay the strong position of the state by referring to the fact that state-owned shares constituted less than 50 per cent. Yet this makes no difference to this position as principal shareholder.

In the case of the banks, the government also seems to have made efforts to coordinate its role as shareholder in more a regulated manner than is the case in industry. Under the auspices of the Fund, and an advisory group consisting of the Governor of the National Bank, the Minister of Finance and the Chairman of the Executive Committee of

⁸⁴ Ormi-database 4 January 1995.

⁸⁵ There are very few enterprises where the state holds a majority of shares. Yet, as shown here, the state has considerable interest in the commercial banks. If the shares held by the investment funds are combined with those held by the state, the efficacy of the legal amendments must be questioned. Yet, because of the public outcry resulting from the dinner party, the political costs for the government will probably be an efficient deterrent.

⁸⁶ Dr. Livia Klausová, the wife of the Prime Minister, is a member of the board of the Czech Electricity Works ČEZ. She was nominated by the Minister of Industry Dlouhý. The Fund for National Property is the major shareholder in the ČEZ. See: RFE Daily Report - database 114 (1994).

⁸⁷ K e r o u š: Privatization of Czech Banks 4.

⁸⁸ The Prague Post 25 January 1995.

the Fund was established. This group meets regularly and issues guidelines for those who represent the Fund in the statutory bodies of the banks⁸⁹.

However, state ownership is not restricted to the banks. At the end of 1994, the Fund still retained approx. 40 per cent of all shares transferred to it. The transfer has therefore been a far slower process than initially envisaged, and according to statements by Roman Češka, the process will probably not be completed until 1997⁹⁰. But thereafter, the Fund will continue to represent the ownership interests of the state in enterprises where the government maintains a stake. State ownership will most likely embrace enterprises and firms that supply infrastructure services (waterworks, railways, etc.).

The consequence of this cross-ownership is that the investment funds are functioning as the extended arms of the banks rather than of the individual investors, the ability of the latter to influence the investment funds being very limited. Despite suggestions for creating mechanisms for 'proxy voting', permitting a single shareholder to act on behalf of a group, all efforts have been stranded due to lack of interest⁹¹. Dr. Lubomír Mlčoch, a prominent economist, has concluded that what the new ownership structure actually amounts to is a tautological transformation of state-owned enterprises into enterprises owned by the state⁹².

Mlčoch's conclusion is partially correct formally, though it fails to reflect the whole truth. By transferring ownership control from the state bureaucracy to the banks, a greater emphasis on market-relevant criteria would stand a better chance of being achieved. The banks were expected to evaluate the enterprises according to market criteria and only give loans to enterprises with profit prospects. Enterprise management would be compelled to base their decisions on a similar yardstick and thus production would be geared to the needs of the market and not the central plan as in the past. This was clearly expressed in a directive entitled "Information for Enterprises about Economic Conditions", issued to the enterprises by the Ministry of Finance on 2 January 1991, i. e. the day after prices had been liberalized. Here, the enterprises were informed that the banks were now the executors of control, and the enterprises would have to respond to the interest rates and credit limits imposed by the various commercial banks, and not to centrally given directives as in the past⁹³. This was, the government declared, a temporary measure until such time as more classical methods could be applied. What these methods amounted to was not specified, but the future introduction of an efficient bankruptcy law was among them. The directive removed monitoring responsibility from the state bureaucracy and transferred it to the commercial banks. This also implied that the enterprises were no longer to count on state subsidies.

⁸⁹ K e r o u š: Privatization of Czech Banks 5.

⁹⁰ The Prague Post 1 February 1995.

⁹¹ P o d n e c k ý, Daniel: Investiční privatizační fondy – Hlasování v zastoupení [Privatization Investment Funds – Proxy Voting]. *Ekonom* 50 (1992) 27.

⁹² *Prager Zeitung* no. 15, 1994.

⁹³ *Hospodářské noviny* 2 January 1991.

The banks and the enterprises

The enterprises had to face the institutional changes with scant financial means, enterprise cash holdings having to a large degree been depleted as the result of a shopping spree undertaken in 1990, when price controls were still in place. Purchasing input materials at state set prices would enable the enterprise to reap a handsome profit if the finished product was sold after the 1991 price liberalization.

In a few cases, management had been able to sell the enterprise to domestic or foreign buyers with the consent of the founding ministry, the sum generated being ploughed back into the enterprise as investments. With the enactment of the privatization laws, this practice ceased and all income from sales were thereafter transferred to the Fund for National Property. Enterprises owned by the Fund were obliged to turn to the banks to finance their needs.

It was beyond doubt that the investment needs in certain sectors of the economy were considerable, though the exact magnitude was impossible to calculate in 1991. Estimates produced by management in the basic privatization projects were apparently not regarded by the banks as relevant. Heavy industry had been a privileged sector in the past with easier access to capital than production of consumer goods. But even within heavy industry, transforming production to meet requirements on Western markets would require fresh capital. Given the rapid changes, management lacked the basis for drawing up realistic development plans for their enterprises, and the unpredictability of future market demands as well as anxiety about their own position were only two of the causes of the so-called pre-privatization paralysis that set in. The time horizon being drastically shortened, planning more or less amounted to a day-to-day strategy for survival in the period immediately following 1989. This was reflected in the fall in investments by 25 per cent in 1991⁹⁴. In the industrial sectors where outlook for the future was most sombre, the fall was even greater. In engineering, investments fell by more than 50 per cent, and in machine-building the 1991 level was only two-thirds of the previous year⁹⁵. Investments were also negatively influenced by the ongoing process of demonopolization. Units that were singled out and transformed into independent firms were suddenly cut off from internal enterprise capital funds.

The ability of the banks to provide the enterprises with financial assistance was constrained by numerous conditions making them less than the neutral arbiter the government aimed at. First of all the banks were short of cash, secondly their credits had been given to former state enterprises with very unpredictable prospects. It was therefore feared that the banks would become hostage to the enterprises. The politicians had little faith in the banks acting sufficiently restrictively when granting new loans. To counteract such a development, severe credit limitations were imposed by the state and remained in force till the end of 1992⁹⁶. As in the case of evaluating the enter-

⁹⁴ Statistická ročenka České a Slovenské Federativní Republiky 1992. Prague 1992, 219, table 8-5.

⁹⁵ Ibid.

⁹⁶ Hospodářské noviny 25 June 1992.

prises, the state was at a loss over what yardstick should be applied when determining the limit. It was therefore decided to use the investment levels from the last years of planning as a point of departure.

The fact that the limits imposed did not correspond to real needs is beyond doubt. But what is more interesting is that the banks exercised more caution than had been anticipated with the result that the credit limits were not reached. Although the Fund representatives on enterprise boards were given the mandate to ensure that the manager took no inappropriate business risks, the banks and not the Fund would carry the costs if they did so. Accordingly, the banks adopted a wait-and-see attitude, mainly issuing short-term credits and avoiding any sort of long-term commitment.

A bank takeover of the enterprise and subsequent sale of assets to cover the outstanding sums was no feasible solution. The enterprises would fetch less than their book value, and this would clearly entail a loss for the banks. Yet, "bad debts" were more prevalent in inter-enterprise relations than in bank credits. Enterprise ability to service their loans differed considerably according to industrial sector and enterprise size. The most indebted firms were the largest industrial enterprises, and the most indebted sector was, not surprisingly, heavy industry⁹⁷.

The monitoring of inter-enterprise debts had been reduced by the formal changes. The enterprises were required to provide the bank with data on liabilities when applying for loans, but the validity of these estimates was often dubious since they could easily omit data on defaulted payments. This, together with uncertainty of the very survival of the enterprise, reduced the banks' willingness to grant substantial credits on a long-term basis. Faced with this, inter-enterprise debts increased until signs of a slight decline appeared in 1992. There seems to have been a tendency for the largest industrial enterprises to obtain new credits from the banks and service old loans and debts to other enterprises⁹⁸. Thus, former inter-enterprise debts have been transformed into bank loans. Not surprisingly, the share of risky loans in the portfolio of the commercial banks, i. e. credits the banks experience great difficulties in retrieving, has increased from 2.4 per cent in late 1991 to 23 per cent in October 1993⁹⁹. This development has threatened the viability of the banking sector. The effects of bank collapse would clearly have dire consequences for all the enterprises in bank's portfolio, including those showing a profit.

The state and the banks

To relieve the banks of bad loans, the Ministry of Finance decided to establish the so-called Consolidation Bank in 1991. The Bank was intended as a transitional emergency instrument owned by the state. In 1991 and the following year, the Bank purchased from the commercial banks approx. 50 billion Crown of bad loans, i. e. far below all estimates of the total sum of bad debts¹⁰⁰. The funding for this purchase was allocated

⁹⁷ Čapek, Aleš: The Bad Debt Problems in the Czech Economy. *Most-Most* 3 (1994) 59–70.

⁹⁸ *Ibid.* 62.

⁹⁹ *Ibid.*

¹⁰⁰ *Prager Zeitung* no. 40, 1992.

from the Fund for National Property. One may perhaps have expected that this sum would have been allocated from the state budget, as indeed is common practice in most market economies. The Czech government circumvented this, thus not endangering the budget balance.

What should be noted here is that this measure benefited the banks, and not the enterprises which were the source of the problem. The establishment of the Bank was a necessary measure to direct fresh capital into the banking sector, but the statutes of the Bank failed to state what the criteria for transferral of bad loans should be, and much was left to the discretion of the Bank staff. Without clear guidelines, they rapidly became subject to pressure from the largest banks. As a result bad loans continued to be relocated from the commercial banks to the Consolidation Bank. Moreover, when some of the smaller banks collapsed early in 1994, the loans involved were transferred to the Consolidation Bank. Therefore, bad loans other than those dating from the period of planning have also ended up in the Consolidation Bank. No specific measures existed protecting the Bank from accepting new loans. The commercial banks could apply for transfer, but the Consolidation Bank board decided whether these loans should be purchased. Not until late summer 1993 was a meeting convened by the National Bank to draw up new guidelines. What the effects have been remain unclear.

The Bank was, by virtue of its involvement, transformed into a potent tool for the government, and a tool it apparently wants to preserve. At the beginning of 1994, there seemed to have been a change in the plans for the Bank's future. The general director announced that it would be transformed into a commercial bank with a range of services not differing substantially from any other¹⁰¹. This statement was issued at a time when the Bank had started to play a active role in business transactions going beyond the initial conceptual function of the bank as a relief organ for the banking sector. The Bank has headed a group of commercial banks providing fresh credits for a large chemical plant¹⁰². Moreover, after two years of Air France ownership of shares in ČSA (Czechoslovak Airlines), the Czech government managed to persuade Air France to sell its shares to the Consolidation Bank¹⁰³. The government could have opted for a re-transfer of the shares to the Fund for National Property. Deciding to allow the Bank to become holder of the shares not only strengthened the Bank's long-term profit perspectives, but also signalled that the Bank no longer was to be a solely transitional measure. This was confirmed early in 1995, when Roman Češka declared that the Bank was among those assets that although they could be, they would not be privatized¹⁰⁴. The National Bank has long desired such a move, and has been opting for allocating some official services like the administration of state boards to the Bank¹⁰⁵.

¹⁰¹ *Ibid.*

¹⁰² Czech and Slovak Investment News 17 January 1994. In: Brom/Orenstein: *The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy* 902.

¹⁰³ *Hospodářské noviny* 15 March 1994. And: Carolina-Database 153 (1995).

¹⁰⁴ *The Prague Post* 1 February 1995.

¹⁰⁵ Vlastimil Tesař expresses the views of the National Bank in Kerouš: *Privatization of Czech Banks* 19–23.

By 1994, the Consolidation Bank had become the fifth largest creditor Bank in the Czech Republic. Yet its influence extends much further, the Bank was creditor to approx. 80 per cent of all large- and medium-scale enterprises¹⁰⁶. Whereas the government showed little interest in taking advantage of its role as shareholder when the enterprises were in possession of the Fund, the activity displayed by the Bank in business transactions as well as the expansion plans, seems to indicate a change toward a far more active state policy concerning enterprise management. One opportunity to do so would be posed by enterprises entering into bankruptcy proceedings. The role of the Bank as creditor means that its representatives will participate in negotiations that will decide whether an enterprise will survive or not.

The bankruptcy law

Another way of avoiding bank collapse was to prevent enterprise collapse by restraining the possibility of bankruptcies. Yet such an option would contradict the contents of the "Scenario" since introducing market forces implied exit mechanisms for enterprises producing at a loss. Moreover, restraining the exit option would mean that the state would have to foot the bill. This had been the case when a few enterprises were closed by the Ministry for Industry and Trade. All enterprise debts had to be covered by the Ministry. It was considered far more advantageous to privatize an enterprise, even if the sum obtained was negligible¹⁰⁷.

A law on bankruptcy was passed by Parliament in October 1991. The political statements accompanying the debate on the implementation of the law clearly showed a very reluctant attitude. When explaining the postponement of the law, Minister of Industry Dyba declared that "the Czech government was not calling for bankruptcies and would not initiate them"¹⁰⁸. This view was shared by Prime Minister Klaus, who stated that the introduction of the law would be "inappropriate given the current economic environment here"¹⁰⁹. Politically, it was untenable to claim that the market had been introduced when a bankruptcy law was lacking. Nevertheless, when the last postponement expired in April 1993, the law remained virtually without effect. Despite widespread insolvency in the enterprise sphere, the number of bankruptcies only amounted to 60 in 1993 and 288 the following year¹¹⁰. Private entrepreneurs agricultural and housing cooperatives make up the largest share, larger industrial enterprises being virtually absent from the list.

Alone the intertwining of ownership between the state and the funds is a powerful deterrent against bankruptcies. Yet, the law contains a number of conditions and protectionist clauses that not only reinforces this effect, but clearly shows the government's intention of preserving full employment. For instance, in all cases of all enterprises

¹⁰⁶ Brom/Orenstein: *The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy* 901.

¹⁰⁷ Lecture by Jaroslav Borák, Director of metallurgy, machine industry and electrical engineering, Ministry of Industry and Trade, Charles University, 27 May 1993.

¹⁰⁸ Central European Business Weekly 19 November 1993.

¹⁰⁹ Prognosis 16 (1992).

¹¹⁰ Statistics provided by the Czech Ministry of Justice, printed in *The Prague Post* 1 March 1995.

affected by voucher privatization, i. e. the great majority, bankruptcy proceedings cannot be opened before the change of ownership was terminated and new owners informed. Whether that means that the enterprises where the Fund for National Property still has shares are exempt, since the Fund may argue that the transfer of property rights has not been finalised, is not known. Even in cases where all shares have been transferred to new owners, the state can intervene and prevent a bankruptcy. The law specifies that the creditor and debtor will be given a time limit of 90 days for negotiating a settlement. But this time limit can be exceeded if an economically important enterprise is involved or if the court believes that an extension would be in the interest of the public¹¹¹.

The government decides when this paragraph may be invoked. If so, the Consolidation Bank can intervene with assistance. But in order to do this, exactly the same measures must be taken and requirements fulfilled that the government had seemed unwilling to enter into during the privatization process. A fixed set of criteria must be developed to provide a genuine picture of the enterprise's financial health. The Consolidation Bank must be strengthened with sufficient staff to undertake long term monitoring.

The law opened up the possibility that the banks could initiate court proceedings against enterprises defaulting their loans. Yet it was feared that this would lead to a domino effect, where the stoppage of production in one enterprise would have wide repercussions for other enterprises¹¹². This was also the reason why the banks clearly voiced that they were against the bankruptcy law, and that they did not have any intention of introducing legal measures against insolvent companies. In spite of the demonopolization procedures that had been undertaken to break up the large monopolies, the links between producers and sub-deliverers were still close¹¹³.

The official resistance to introducing a fully operational bankruptcy law is due to the fact that the collapse of one enterprise would spark off a row of bankruptcies. This fear is due to the links between the enterprises in one industrial sector which functioned as a network during planning. Although the demonopolization and detatization of the enterprises has changed this, at least formally, the network between the sub-deliverer and the producer of the finished product is so intimate that detrimental effects would surely be felt. The interrelatedness of the enterprises has further been strengthened by the inter-enterprise debts. Those enterprises that could sue another for bankruptcy will usually not do it, because it would virtually eliminate their chances of recovering the debts.

To prevent bankruptcy proceedings from being introduced against an enterprise, the law opened up state financial support to those that would stand a chance of surviving. If no comparable employment can be found within a reasonable distance, the state could provide financial assistance. Of the 76 local government districts, 16 were claimed to fulfill this requirement¹¹⁴. The financial aid from the state will be

¹¹¹ The Privatization Process in Central Europe 65.

¹¹² *Hospodářské noviny* 21 May 1993.

¹¹³ Klvačová, Eva: Tendence k demonopolizaci se neprosadila [The Demonopolization Trend has Faded Out]. *Ekonom* 35 (1992) 19–20.

¹¹⁴ *Prager Zeitung* no. 18, 1994.

administered through the Consolidation Bank through purchases of the insolvent enterprises' loans. A sum will be set aside by the Fund for National Property for this purpose; 10 billion Kč were mentioned as a potential limit¹¹⁵. But the law allowed for direct subsidies from the state budget if this sum would not suffice.

The parts of the Czech Republic with the highest unemployment levels are also regions with high concentrations of heavy industry. This means that there will be strong disincentives for the government to allow bankruptcy proceedings to be introduced against the same sector many had recommended should be reduced prior to 1989, at a time when they were working as scientists.

An economy in search of an adjective

On 1 January 1995, the second and final wave of the coupon privatization ended. Recalling Prime Minister Klaus statements to the Czech Economic Society in 1993 (see note 12), Privatization Minister Jiří Skalický declared that the most important phase of privatization had ended¹¹⁶. That may be so, but the state's ownership remains pervasive. The Fund for National Property remains with either a majority or the largest number of shares in many enterprises. On average, the Fund holds 20 per cent of the book value, with the mainly state-owned banks possessing a further 40 per cent¹¹⁷. If one adds to this the fact that the Consolidation Bank is a major creditor to the enterprise sphere, state omnipotence is evident.

There are some conclusions that should be drawn from this. The most evident is that the concept 'privatization' is inappropriate. What has happened is a partial de-etatization of the economy. Klaus' definition of transformation as a comprehensive change affecting the entire system cannot be applied to the Czech transition because the financial problems at enterprise level have remained. There have been no comprehensive attempts to solve them; instead ad hoc solutions that were intended as temporary emergency operations have become a permanent feature: e.g. the Consolidation Bank, the impotent bankruptcy law, and of course state ownership. The most recent suggestion by the government to grant industrial enterprises tax relief to enable them to pay their debts¹¹⁸ contradicts all political pledges aimed at ending the old system of "social indolence" (see footnote 2). This policy does not only mean less income for the state, but also less capital available for private entrepreneurs starting from scratch.

There is little doubt that the overriding concern for the policymakers has been the need to retain social peace and through this political stability. In the "Scenario", the need to let social considerations decide the pace of economic reforms was understood to be an argument in favor of rapid reforms. The concern has remained consistent, but the outcome has been marked by considerable pragmatism. An effective bankruptcy law, refusing financial aid to banks and enterprises, would certainly have led

¹¹⁵ Ibid.

¹¹⁶ The Prague Post 25 January 1995.

¹¹⁷ Brom/Orenstein: The Privatised Sector in the Czech Economy: Government and Bank Control in a Transitional Economy 894.

¹¹⁸ Mladá fronta Dnes 4 April 1995. Quoted by Omri - Database 4 April 1995.

to massive unemployment with disastrous effects for the reforms. It would have alienated large sections of the population and provide fertile ground for extremist groups. Thus, including political stability as a criterion for evaluating economic reforms will yield a more positive conclusion than would have been possible if the focus had been restricted to the efficiency of market mechanisms.

But political stability is an elusive quality. An analysis of the Czech transition should therefore focus on whether the government has taken advantage of it to build the institutional preconditions for a political stability that can resist the pressures of economic crisis and social unrest. It is easy to forget that the economy moves in cycles, and that the boom we are experiencing at present may be as short-lived as it is recent. Admitting that, an assessment is far more challenging than merely asking to what degree the Czech economy has moved toward its goal. No clear-cut answer can be given, and based on the discussion of the state's role in the economy presented here, a conclusion cannot avoid being contradictory. The voucher privatization was a success in that it created popular support for the transition. But it has disguised the considerable role played by the state. The numerous solutions applied by the government in support of the economy seem less to be the outcome of a grander strategy or preconceived plan than of ad hoc solutions. That is understandable given the turmoil any transition from one economic mode to another is bound to produce, but what is worrying is that the state so far has only been used as an emergency saviour. Although the banks can be said to have initiated important measures aimed at a long-term restructuring of the enterprises, the lack of efficient exit mechanisms has erased the possibility of hard budget constraints for the former nationalized enterprises. That will deter any radical change at the enterprise level toward more market adequate behaviour. That is not to say that everything persists as it did prior to 1989, but it illustrates to what extent economic development is constrained when the political understanding of state participation in the economy is viewed negatively, and, when resorted to, is not given any clear-cut guidelines.

In this perspective, the fact that state support for the enterprise sphere is provided is of secondary importance. What should be criticized is the manner in which state aid and ownership are undertaken. The government is at present using state ownership to bail out large-scale industrial enterprises. Social peace is retained, but the lack of transparency has so far undermined any efforts to create a predictable institutional framework for the economy to develop, irrespective of whether the government has settled for Thatcherite liberalism or a mixed economy with a large say for the state. In that respect, the ad hoc development of state participation in the economy has undermined the overriding aim of any transition: creation of a predictable framework for the economy. With increasing predictability, enterprise managers can start restructuring the manufacturing process, and state support can be given to development of new industrial items instead of simply keeping the enterprises afloat. If Western demand for cheap, semi-processed goods is reduced, or the export of Ukrainian ore ceases, the political leadership will find it extremely difficult to impose a limit on how far state support can extend, in particular since no advantage was taken of the present period when social tension is low. In that respect, the long-term political consequences of the economic transition may well be negative.