Transition Newsletter
THE NEWSLETTER ABOUT REFORMING ECONOMIES

Pretence of Market Economy and Legacy of Old Regime—Political Economy of System Transformation

by Tsuneo Morita

In 1993–1994 many economists referred to the "Czech miracle," thought to have been accomplished via radical voucher privatization. While enthusiastically praising Czech-type privatization characterized as "shock therapy," they harshly criticized the Hungarian-type privatization characterized by reluctant gradualism. In my book *Taiseitenkan no Keizaigaku* (*Economics of System Transformation*), published in Tokyo in 1994, I pointed out that with the Czech miracle, voucher privatization couldn't solve the dilemma of corporate governance.

In 1996 economists and analysts already began to mention weak corporate governance and delays in restructuring voucher-privatized Czech companies. Gradually it became clear that managers of quasi privatized Czech companies established various types of subsidiaries, made money flows complex and non-transparent, and acquired individual wealth by leaking money through subsidiaries to their own registered companies—called tunneling.

Apples and Oranges

Many economists thought that transformation from a so-called planned economy to a market economy could be accomplished in a relatively short period, providing government was able to boldly liberalize economic activities, speed up privatization, and establish the legal infrastructures of a market economy. Therefore, some international finance institutions took these criteria as progress indicators of market economy, as if a market revolution can be achieved at the same speed as a socialist revolution.

Comparison is reasonable if the countries compared are at the same stages of social development. However, if they are at different stages of social development, then comparison of common criteria yields little meaningful information. In other words, is it meaningful to compare weight increase among pigs, cows, sheep, and chickens? It may be more meaningful, for instance, to compare the market developments in Central Asian countries separately from the performances of Central European countries.

In successive Transition Reports of the EBRD, the Czech Republic has always come first in country rankings based on private sector share in GDP, thanks to its voucher privatization. The EBRD indicator is based on the legal transformation of state companies into joint-stock companies. Even if the government keeps a majority stake, the company automatically classifies as a private one, regardless of its actual status. Thus, formally transformed companies, actually controlled by the state, are counted as private firms.

Recipe for Getting Rich Fast

In many cases voucher privatized companies lack effective and responsible management. Instead, a single manager, or set of managers, is legally appointed by the government and has an overriding power to manage and execute business and political activities that maintain and strengthen his or her position. These appointed managers often are bureaucrats, politicians, or reform intellectuals from the old regime who succeeded in surviving amid the new surroundings.

For example, the government keeps a 40 percent stake in Russia's huge gas monopoly, Gasprom. Ex-bureaucrats and ex-central bankers, appointed by the government, carry out managerial and supervisory roles. The firm, once under the supervision of the Soviet Gas Ministry in the 1980s, was run by Victor Chernomyrdin. After the collapse of the Soviet Union, it transformed itself into a capitalist monopoly, setting up its own financial institutions and buying enough stakes in various banks to become a leading financial-industrial group. Other industrial and financial groups in Russia have similar stories. In many cases the elite of the old regime are playing key roles just by changing their positions and functions.

The Postabank Nightmare

In Hungary, Postabank remained the only large commercial bank in state ownership. Other big banks had been privatized and taken over by foreign strategic investors. More precisely, not even the government had a controlling stake in Postabank. A carefully divided ownership structure was designed to prevent effective control over the management. It was masterminded by Gabor Princz. It was his initiative to establish a commercial bank by utilizing the nationwide post office network . He became CEO of Postabank after being a junior officer at the National Bank of Hungary.

After the opposition party won the general election in 1998, the new government immediately dismissed the old management together with Princz, who had reigned for ten years. The new management revealed that the bank—thought to be financially sound—had in fact accumulated a loss of about 150 billion forints ($700 million). The loss was derived mainly from various suspicious real estate investments both in Hungary and abroad, risky portfolio investments, loss-making media holdings, and various thefts. Princz's monthly salary of 8.8 million forints was 500 times higher than the minimum wage and 150 times higher than the average wage in Hungary.

At the end of the 1980s when commercial banks were established by dividing up the functions of the National Bank, many senior officers moved from the central bank to commercial banks as managers of newly established banks. How was it possible for state bankers to earn large amounts of money and decide on almost everything as private bankers do without effective state control?

- First, the government argued that competitive payment system was required to keep competent bankers in state banks.

- Second, the managerial and supervisory function of the government as majority owner didn’t work. Most government officials formally represented the state at the boards of directors as a private second job, without taking due responsibility.

- Third, politicians were eager to maintain good relationships with state banks and expected money to finance their political activities in return.

- Fourth, astute managers, like Princz, distributed money to all main political parties and invested in newspapers and magazines that were thereby incapable of dispatching unbiased information to the public.

The Root of Corruption

In most transition economies prosecutors initiated few indictments in connection with bribery and corruption; partly because quasi bribery is de facto legalized in these countries and partly because prosecutors are traditionally weak and can not insulate themselves from political pressure.

Many high-ranking politicians in these countries buy luxury cars and build mansions shortly after winning in the parliamentary elections. How is it possible to earn that amount of money through uncorrupt politics in the transition period?

- Politicians of a governing party can get insider information about privatization plans. If direct participation of politicians is not possible, they delegate family members and co-operators. If winning an international tender is at stake, then the amount of the "success fee" for lobbying can be enormous.

- The ruling party has decisionmaking power in redistributing budgetary expenditures. Politicians, if awarded, can forward insider information about the money flow. They can also lobby for changes in the distribution pattern, for budget spending on specific projects.

- Not only bureaucrats but politicians, including members of parliament, are being appointed as supervisory board members to quasi privatized and fully privatized companies. The amount of individual honorarium may not be significant but it multiplies when the same person takes on nominal supervisory jobs that are offered by company mangers looking for political and governmental connections. The honoraria are conceived as complementing the low salary of the bureaucrats. However, this practice leads to various types of corruption contrived by government officers and company managers.

To sum up, in East and Central European societies corruption is widespread, social disciplines and ethics are low, and demand for social justice is weak. Therefore social disciplines and ethics should be restored for rolling back de facto briberies and corruption effecting government and semi-privatized institutions. Governments should motivate people to play a more active role in business and social life, not only through economic measures but also by establishing rightful social normative in public life.

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The above article is based on Mr. Norita's lecture "Culture and Modernization in Light of the Japanese and Central European Experience," *delivered in December 1998, Cracow, Poland.*

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