

The Economic Transformation of Eastern Europe: the Case of Poland

JEFFREY SACHS

Harvard University, Economics Department, Cambridge, MA 02138, U.S.A.

Abstract

This article identifies the main features of Poland's radical transition to capitalism – stabilization program, trade liberalization, and privatization reform. The 'shock therapy' adopted by Poland in 1991 is presented as the most effective approach, though not without political risk. In fact, the major threat to Poland's transition process is the emergence of well organized 'interest groups' putting increasing demand on the government to relax financial restrictions and re-open large-scale subsidization. These political pressures have already caused a slowdown in the privatization program, so that there is a possibility of the renewal of rapid inflation. Several methods for accelerated privatization, including the distribution of vouchers and setting up investment funds to manage portfolios of shares, are discussed in detail.

1. Introduction

In virtually every aspect of economic life, the communist legacy is adverse.¹ Normal market institutions were destroyed by the communist rulers in the early post-war period, so that even the most basic categories of economic life in a market economy – corporations, bankruptcy law, securities trading, collective bargaining – must be painfully reconstructed. For four decades, capital spending was dictated by political fiat, in a system that valued heavy industry to the neglect of basic consumer needs, and that ruthlessly reoriented trade from Western Europe to the Soviet Union.

The economic effects of the communist period are just now coming into clear view among analysts in the East and West, and the picture is even worse than expected. Living standards in Czechoslovakia, Hungary, and Poland are now estimated to be at the levels of the middle-income developing countries of Latin America, and far below the levels of even the poorer countries of the European Community.² At the same time, the industrial structure seems even less suited to the requirements of competition in world markets than was hoped, and the environmental degradation caused by decades of disregard for the environment constitutes another urgent and costly legacy of the previous regime.

2. The economic reform program in Poland

The deficiencies of Poland's economic structure are evident across the economy: an overgrown and inefficient heavy industrial sector completely protected from international competition; an underdeveloped light industrial sector; a neglected and undersized service and distribution sector; a particularly inefficient and underdeveloped financial sector; and a technologically backward agricultural sector, in which millions of poor farmer households work tiny plots of land.

Poland's economic reform strategy does not aim to address these problems mainly by direct intervention in these sectors, but rather through the generalized introduction of market forces which will guide most of the needed restructuring. For this reason, we have to think about Poland's economic transformation from two perspectives. The first is the timing and content of the reforms; the second is the timing and content of the actual restructuring that will take place as the result of the reforms. The reforms themselves can and should be introduced quickly, in three to five years. The restructuring, on the other hand, will necessarily last for a much longer period, presumably a decade or more, since there must be time enough for a substantial buildup of investments in new sectors of the economy in response to the newly introduced market signals.

Poland's comprehensive economic reform program has three main types of policies. Economic liberalization is the broad rubric for all of the legal administrative changes needed to create the institutions of private property, and to introduce market competition. Macroeconomic stabilization involves measures to limit budget deficits, reduce the growth of the money supply, and establish a realistic and uniform exchange rate for the currency, in order to create a working monetary system based on a convertible currency and stable prices. Privatization includes the wide range of measures needed to transfer ownership of state property to the private sector. Note that there are two ways that the private sector will develop: through the formation of new firms made possible through economic liberalization, and through the privatization of existing state property.

I should also stress that the steps of liberalization, stabilization, and privatization do not exhaust the range of key governmental actions over the economy. In addition, the government must make certain that there is a strong social safety net in place at the time of reforms in order to prevent the reform actions from gravely affecting the most vulnerable parts of the society. This was in fact fairly readily accomplished in Poland, since the old régime had already in place many of the needed social measures. New measures, such as unemployment insurance, were introduced at the outset of the program. Also, the government must oversee a public investment program, mainly for needed infrastructure, as a complement to the restructuring of the economy.

Poland's strategy has been to introduce the three main pillars of reform as rapidly as possible, an approach that is being emulated widely throughout Eastern Europe. The motivation for comprehensiveness and speed in introducing the reforms is clear cut. Such an approach vastly cuts the uncertainties facing the public with regard to the new 'rules of the game' in the economy. Rather than creating a lot of turmoil, uncertainty, internal inconsistencies, and political resistance, through a gradual introduction of new measures, the goal is to set in place clear incentives for the new economic system as rapidly as possible. As one wit has put it, if the British were to shift from left-hand-side drive to right-hand-side drive, should they do it gradually, say, by just shifting the trucks over to the other side in the first round?

If we examine the timing of reform actions more carefully, we note that many of the key steps of economic liberalization can be introduced very quickly, indeed virtually overnight by a well-prepared government. The crucial steps of establishing free trade, market pricing according to the forces of supply and demand, key aspects of commercial law and private property rights, and the end of state orders and central planning, were introduced in Poland in the space of a few weeks at the end of 1989 and the beginning of 1990.³

Macroeconomic stabilization can also be achieved relatively quickly, with key steps of eliminating the budget deficit and tightening monetary policy in Poland taken at the time of the 'big bang'. The need for quick macroeconomic action in Poland was particularly acute, since the weakness of the last communist government and the final breakdown of the old régime had led to an extraordinary financial destabilization that was capped by a brief period of hyperinflation at the end of 1989. The hyperinflation would surely have intensified save for the decisive actions of the new Solidarity-led government which came to office at the end of 1989.

On January 1, 1990, the new government took stringent macroeconomic measures, including large cuts in budget subsidies (which meant higher prices passed on to consumers), higher tax collections, wage controls, and a sharp devaluation of the currency. These measures, together with the elimination of most price controls as part of the economic liberalization, led to a large one-time jump in the price level, of nearly 100 percent in the month of January, 1990! But soon after this extraordinary one-shot jump in prices, the new economic environment brought a rapid end to the high inflation of the previous year, and even more remarkably, a rapid end to decades of chronic shortages and queues.

Without question, privatization is the most challenging and time-consuming of all of the steps of the reform program. Many countries around the world have sold state enterprises to private investors in recent years, but none has faced the magnitude of the challenge in Poland and

the rest of Eastern Europe. Under the communist regime in Poland, more than 90 percent of industry, in roughly 3000 industrial enterprises, was in state hands, and the share of state ownership was also very high in other parts of the non-agricultural economy.

To put the issue into perspective, consider the fact that under the aggressive privatization campaign of the Thatcher era, and U.K. succeeded in privatizing approximately 50 enterprises during the 1980s, roughly 5 firms per year. At the Thatcherite rate (which benefitted from a sophisticated capital market and a large private sector to absorb the state firms), the Polish task of privatization would take several hundred years. 'British-style privatizations' cannot be the main answer for Eastern Europe.⁴

The basic framework law for privatization was put in place in mid-1990. Under this law, privatization has proceeded remarkably rapidly for small firms, such as retail shops, for which privatizations are mostly controlled by local and regional governments. Poland has succeeded in leasing or selling more than 40,000 shops to private operators by mid-1991. It is estimated that as a result of this 'small-scale privatization', as well as the rapid growth of new private firms in the service sector, roughly 80 percent of retail trade is now carried out by the private sector. Privatization has also been very rapid in trucking, construction, and small industrial units, where privatization has occurred in part by auctions, and in part by leasing the enterprises to the workforce.

3. Methods of rapid privatization⁵

The original intention among many senior officials in the Privatization Ministry in Poland was to carry out the process of privatization mainly through initial public offerings (IPOs). The attempt to rely mainly on IPOs was predictably flawed, even though it was urged upon the government by dozens of investment banks used to that method of privatization. IPOs are always time consuming, and local circumstances suggested that they would be especially difficult in Poland, where there are no capital markets; no domestic investment banks; a stock exchange which only began operations in April 1991; no reliable basis for the valuation of enterprises; low levels of household financial assets with which to purchase shares; and thousands of enterprises to privatize.⁶

In the summer of 1990, the government had the intention to privatize around 20 enterprises by IPOs during the second half of 1990. In the fall, this was scaled back to 5 enterprises. These enterprises were offered for privatization via IPOs in December. When the shares were undersubscribed for some of the firms, the closing date was extended to early January. In the event, only three of the five enterprises were fully subscribed by the general public; the shares of the other two were

purchased by a new state development bank in order to complete the IPO.

3.1. Ownership to insiders

A far simpler method of privatization is to transfer the ownership of the enterprises to the insiders, that is, the management and workers in the firms. This can be done rapidly through direct giveaways, leveraged buyouts, or some combination (leveraged buyouts at concessional prices). Indeed, it would be possible, were it desired, to give away the entire enterprise sector to the current insiders in a very short period of time. Transfers or sales of shares to insiders should be widely employed – and more widely than is now the case – but should be subject to clear standards and limitations.

One key problem here is fairness. While insiders should surely receive some explicit property rights in their enterprises to compensate them for their current implicit property rights, a complete transfer of enterprises to the insiders at very low prices would unfairly benefit the insiders relative to the rest of society. The work force in state industrial enterprises totals about 3.6 million workers in a labor force of 18 million, and a population of 38 million. Some workers are in highly profitable enterprises while others are in bankrupt enterprises.

Another problem with insider privatization is efficiency. In general, worker ownership is desirable neither for the workers, who should diversify their capital, not concentrate it, nor for the capital structure of the firm, which should have outside owners as well as inside owners. A firm owned mainly by its workers tends to be isolated from the capital markets, since potential outside investors are concerned that inside owners (who control the firm) will appropriate the profit stream. Worker owners, for example, will have the incentive to push for excessive wage increases at the expense of the outside investors.

The public's outrage against spontaneous privatizations by managers, and the economic team's worry about worker ownership in the large enterprises, led the government in 1990 to resist insider privatization in favor of outsider privatization via public offerings. But the reactions probably went too far. The simplest methods of privatization – direct sales or transfers to the insiders – have been underutilized, while the harder methods (such as IPOs) have been overemphasized.

The Polish Privatization Law passed in July 1990 attempted to allow for, but to strictly limit, insider privatizations. The law allows for a limited concessional sale of shares to workers. Specifically, workers are entitled to buy up to 20 percent of the shares of the enterprise at half price, subject to the proviso that the total value of the concessions to the

workers (the half-price times the number of shares purchased) must not exceed one year's wage bill of the enterprise.

The concessional transfer of shares to the workers has so far played no role in speeding the process of privatization. If the law had simply granted the workers ten percent of the shares for free, then the direct transfer of shares to workers could have been used to speed the privatization process without the agony of determining the 'price' of the shares. And even if the government sticks with the plan to make concessional sales to the workers at half price, it could still choose to use the book value of the enterprise, rather than a market price, as the basis for the sale of shares to the workers.

Since the start of 1991, there has been a promising advance in insider privatization for medium-size firms, generally of about 500 employees or fewer. The government has approved about 100 leveraged buyouts by worker-management groups of these relatively small firms. The worker-manager group seeking the enterprise buys the enterprise with an up-front payment of about 20 percent of value (based on a quick outside valuation that in fact relies heavily on the book value). The rest of the enterprise is purchased with a loan from the government, that is to be amortized over several years.

3.2. Outsider privatization

The government has operated on the premise that outsider privatization (sales or transfers of shares other than to workers and managers in the enterprises) will be the key method for privatization of large industrial firms. There are four different groups of outsiders who can own shares: small investors in the general public; foreign investors; financial intermediaries (banks, pension funds, mutual funds), whose shares in turn would be owned by the general public; and other industrial enterprises.

Of those, the most promising seems to be the reliance on financial intermediaries, as suggested by the practices of the most advanced market economies. Here, more than half of the equity is owned by financial institutions, including banks, pension funds, and investment trusts (or mutual funds). The capitalization of financial intermediaries offers an enormously promising way to proceed with rapid privatization, though this method has been almost wholly unexploited to date. (See Lipton and Sachs, 1990, for a more detailed discussion of the proposals in this section).

The most important opportunity lies in share ownership by commercial banks, as in Germany and Japan. Poland has nine state-owned commercial banks that dominate the commercial banking market (around 50 new private commercial banks have been licensed, but most of these Banks are still very small). These state banks are in the process of being

converted into joint stock companies for subsequent privatization, and the government is aiming to privatize two or three of the banks this year.

The case for giving shares to the banks is very strong. Since the banks are the one existing financial institution in Poland capable of holding and managing corporate equities, it would be natural to use them for this purpose. Moreover, a growing body of international evidence and theoretical reasoning points to the conclusion that banks are excellent candidates for share ownership in that they provide particularly effective corporate governance.⁷

A second way to privatize shares via financial institutions is to capitalize pension funds using the Treasury's shares. Under current arrangements, pensions in Poland are paid entirely by the government on a pay-as-you-go basis financed by a payroll tax. This system could be partially privatized along the lines successfully carried out in Chile in the early 1980s. The Government would deposit a proportion of its equity ownership into several new portfolios, each of which would be managed as a private pension fund by a portfolio-management group licensed by the government.

The specific design of the PMFs has been hotly debated. There are several practical areas of disagreement. Should individuals have the choice whether to receive individual shares of enterprises or shares of a PMF, and should individuals be able to choose their PMF? Should the funds be mostly passive investors, or should the funds be allocated to the controlling interests in individual enterprises? Should households be able to trade their shares of the PMFs without restriction, or should there be a period of time (say, one year) in which they must hold on to their claims? How should the PMF managers be compensated?

The predilection among Polish officials is to create a system of maximal choice for households and the funds. For example, one popular notion is that households would not receive investment trust shares directly, but instead would receive voucher coupons that could be used either to buy equities in individual enterprises or to buy a share in an investment fund. In that scheme, the investment funds would receive vouchers which they would then use to bid for shares from the government, so that the PMFs would have a key role in building its own initial portfolio of shares.

It is also popular among many Polish officials to envision that the investment funds would have controlling interests of industrial enterprises – in some proposals a PMF could hold up to 100 percent of the equity of an enterprise. There is naturally a desire among Polish officials to create powerful ownership groups, modelled on venture capital funds, that could play a key role in restructuring the state enterprises. The investment funds are widely looked upon as the institutions to carry out such a function.

I would strongly opt for a far simpler system, with much less choice at the outset, and with weaker funds, in order to minimize risks and to save

enormous administrative complexities. The process of creating investment funds will require the prompt distribution of shares to 25 million adult Poles in a situation in which there do not now exist any tested institutions of share ownership, brokerage houses, or even established investment funds.

In the interest of simplicity, individuals can be randomly assigned to investment trusts without any choice (e.g. based on the number of their national identity card). In turn, the Treasury's shares would be randomly allocated to the investment trusts, again with no choice. There would seem to be little gain to expending great efforts in auctioning the shares to the investment funds when these funds will be free to trade their initial allocations after they are received. The initial allocation of shares should be designed administratively to meet two criteria: equality across fund portfolios in the reported post-tax earnings in 1990 and equality of the book values of the enterprise shares held in each fund. Subsequent to this initial distribution, the investment funds would be allowed to trade their shares.

I would also strongly argue against allowing the investment funds to gain a majority stake in individual enterprises. In fact, in my view, the ownership of any enterprise by any PMF should be limited to 10–15 percent of the shares of the enterprise. Even though it might seem attractive to create powerful active investors, this should not be done artificially with newly established investment funds that have no management track record and that do not even have the fund managers' own money at stake.

4. The early effects of Poland's reforms

Even in the first two years of economic reform, the combination of liberalization, stabilization, and privatization measures has had a profound and beneficial effect on the Polish economy. In the first few weeks of Poland's 'big bang', Poles were startled to see the end of the shortages which had wracked Poland for decades, as well as the appearance of many new imported consumer goods on the market. Hundreds of thousands of new small businesses started operations in 1990, creating in a matter of months an incredible network of new shops and service establishments, and firms engaged in international trade, construction, and trucking. The development of the service and trade sectors was particularly dramatic in an economy that had long been starved of these sectors.

The economy also quickly adjusted to the opening of markets to international trade. Polish exports to the West surged in 1990, as a result of currency convertibility and the newly attractive exchange rate established at the start of 1990. The surge in exports continued in 1991, and

has helped to pay for a sharp rise in imports as well. The import boom reflects, in part, the eager purchases by Polish households of Western durable goods that were long unavailable and, in part, a substantial increase in machinery imports.

The overall effect in the first two years of the economic changes on the average Polish household is hard to assess. Despite the new availability of goods since the start of 1990, many Poles have complained bitterly about the new, higher prices. The evidence suggests that on average, Poles are now consuming somewhat more meats, fruits, and consumer durables than they were before the reforms, so that greater availability of goods has, on average, more than compensated for higher prices. And without doubt, Poles are now saving millions of hours of time per week that used to be wasted in long queues for consumer goods in scarce supply.

But, of course, average levels of consumption tell only one part of the story. There are surely important groups in the population that have lost ground in the first two years of the reforms. These groups include, for example, the hundreds of thousands of farmers working on tiny and inefficient farms, who have lost the production subsidies that used to help them stay in operation. Similarly, there are hundreds of industrial enterprises, with hundreds of thousands of workers, that are unable to compete under the new market conditions. As a result, there has been a sharp loss of jobs in industrial firms, which has contributed to a sharp increase of the unemployment rate, which has risen to nearly 10 percent in mid-1991.

Not all of the rise of unemployment is due to the reforms, however. Some was always present, but was simply unrecorded by the previous régime, under which unemployment was a crime and not a circumstance meriting compensation. Also, the collapse of the Soviet economy, and the breakdown of trade relations with the Soviet Union, has led to an enormous and rapid decline in exports from Eastern Europe to the Soviet Union. Hundreds of enterprises in Poland and the rest of Eastern Europe are being forced to close their doors, or at least to cut back dramatically on production, as a direct result of the Soviet crisis. The economic reforms in Poland have in fact helped to ease this shock, by creating conditions in which enterprises can shift their exports from the Soviet Union to Western markets. Nonetheless, the loss of national income and employment due to the Soviet crisis is widely attributed by the Polish public to the economic reforms themselves.

The dominant mood in Poland may be described as a grudging acceptance of the need for the reforms, and an appreciation for the achievements to date in ending inflation and shortages, and in promoting the private sector. At the same time, however, there is a deep anxiety over rising unemployment and a profound uncertainty about the future. In a recent opinion survey, more than 60 percent of the Poles said that they feared losing their jobs in the near future. While such fears are

almost surely exaggerated, the fears themselves are real, and they contribute to a pall that hangs over the country.

5. The need for a breakthrough on privatization

Poland has made it more than half-way through the reform process needed to transform itself into a market economy. The price system now works according to supply and demand; international trade is free, and as hoped, both exports and imports are rising; new private firms are forming and growing at a rapid rate. Indeed, Poland already can be considered to have a market economy, but one that still has an overwhelming state ownership of large industrial firms. Poland has so far achieved a form of 'market socialism'.

This is surely not where Poland wants to remain. Market socialism is not only inefficient but, if continued, would almost surely lead to a return of profound macroeconomic instability. The problem is that, in the absence of real owners of the industrial assets, the enterprises lack clear goals, and are not subject to any effective corporate governance. In the West, enterprise managers are governed by a board of directors that is legally obliged to govern the firm on behalf of the owners, with the goal of maximizing the firm's value. While this system poses serious problems of how to make sure that managers and board directors in fact operate on behalf of the owners, at least the legal responsibilities and basic incentives of corporate enterprises are clear.

Under the communist regime, governance was provided by a system of commands from the state administration and the Communist Party, backed up by terror or its threat. With the merciful collapse of communist terror, governance of the industrial sector has also collapsed, with striking and pathological effects. Now, enterprise managers operate on their own behalf, or under the control of a workers' council within the firm. In a small minority of firms, a Supervisory board has been appointed by the government to represent the interests of the treasury as the legal owner of the enterprises. In these cases the workers' council role is eliminated, and the enterprise is made subject to normal commercial law for corporations, a process known in Poland as 'commercialization'.

Throughout the state sector, and particularly in the vast majority of firms that have not been commercialized, there are incessant wage pressures that are not kept in check by managers who represent real owners of the firms. Managers are in fact all too ready to pay out enterprise profits in the form of higher wages. In the absence of centralized wage controls, therefore, there is the tendency towards a wage explosion, of the sort that has occurred in former East Germany (where wage controls were not imposed).⁸ Therefore, wages are now kept some-

what under control in Poland by a system that is economically inefficient and politically debilitating for the government.

Also, in the non-commercialized enterprises, there are reports of widespread self-dealing and conflicts of interest by state managers. Managers have been reported to engage in the following kinds of activities: intentionally bankrupting firms to buy them back cheaply; establishing private firms to do business, in sweetheart deals, with the state enterprises that they manage; accepting unfavorable joint venture and takeover offers that provide personal benefits for the manager, while rejecting favorable offers that put the manager's personal position at risk.⁹

Finally, there are 'zombie' enterprises, in which incompetent managers simply run down the bank balances and other capital of the new market conditions. In the case of many Polish firms that were hit by the collapse of the Soviet market, enterprises simply continued to produce the normal output levels and build up inventories, waiting for a miracle of some sort. Finally, by mid-1991, the bank balances ran out, and a politically and economically troubling spate of insolvencies hit the country. Once again, the absence of a capital market (in which a takeover might occur), and the lack of corporate governance, has contributed to these profound managerial failures.

The proper long-term solution for the industrial sector problems is clear. The enterprises should be privatized, and then restructured or liquidated once under private control. The case for privatizing the firms quickly is overwhelming. The onus on the government for restructuring will be greatly reduced; the pressures from the firms for subsidies and protection will be easier to resist;¹⁰ and, presumably, the private owners will do a better job of saving the viable parts of industry and sloughing off the unviable parts. As mentioned earlier, novel approaches to privatization – based on a free distribution of shares of industrial enterprises – are probably vital to a speeding up of the privatization process. Nonetheless, these novel methods remain controversial and subject to criticisms by various groups, such as managers intent on keeping control over their enterprises.

Before privatization is complete, there is an urgent need to widen the use of commercialization, to bring the enterprises under the governance of Supervisory Boards. While this step does not establish private owners, it does help to establish some modicum of oversight of managerial behavior, and it does subject the enterprise to normal corporate law. Even this step, however, is controversial and slow to be applied in Poland. Some policy makers underestimate the importance of establishing a clear legal framework for the enterprises, while others point to the real, but surmountable, logistical difficulties of finding qualified individuals to sit on the supervisory boards. Still other critics of commercializing worry that, if the process is abused, it could lead to a recentralization of governmental power over the enterprises.

6. Economic restructuring in the medium term

The economic reforms will set in motion a sustained process of economic restructuring. Of particular importance will be the pressures of international competition of Polish industrial enterprises. While we cannot make accurate predictions about the precise long-term consequences of this restructuring, especially as regards which industrial sectors will survive and flourish, and which will decline, we can make some useful predictions about the basic trends that are likely to emerge.

Under communist rule, Poland's economy was heavily skewed towards industry and away from services. This bias was cruelly felt in everyday life, in the form of a shortage of shops and restaurants, miserably inefficient banks, and virtually unobtainable personal services. Once market forces are unleashed, there should be a strong pull of resources into the previously neglected sectors, and out of the overextended industrial sectors. Even in the first eighteen months of the reforms, such trends have been clearly evident. Industrial employment has fallen sharply, perhaps by around one-fourth in the state-owned industrial enterprises. At the same time, hundreds of thousands of new private businesses have emerged in trade, services, and residential construction. While Poland is sometimes described as being in a sharp recession, this characterization in fact applies only to the industrial sector. The economy is actually booming in many of the previously neglected sectors, especially through the formation of new small businesses.

Agriculture is another area where we should expect major restructuring. Poland has a large and inefficient agricultural sector made up of hundreds of thousands of tiny farms. As mentioned earlier, these small farms were sustained despite very low productivity by large subsidies granted by the communist régime to keep social peace in the countryside. Poland therefore has not yet completed the great demographic shift of employment from agriculture to industry and services that has been traversed by nearly every advanced industrial country. As a result of the sharp cuts in subsidies to agriculture in the past two years, many small-scale farmers are now under financial pressure. It should be expected that many small farmer households will sell their farms in the coming decade or two, so that farmlands will be consolidated over time into a much smaller number of larger farms.

The third major trend that we should expect is a complete restructuring within the industrial sector, from energy-intensive heavy industry to more labor-intensive and skill-intensive industries that can compete on world markets. Poland enjoys low-cost, skilled labor, particularly in engineering, that should make the country an attractive place to produce industrial goods for exports to Western Europe. Over time, Western firms, mainly from Western Europe, are likely to set up operations in Poland for the sake of export production, in the same way that European

firms are investing in Spain, or American firms are investing in Mexico, or Japanese firms are investing in Korea, Taiwan, and the rest of Southeast Asia. So far, foreign direct investment has been modest, since foreign investors remain concerned about the lack of clarity in property rights, and about the political sustainability of Poland's reforms. Assuming that the reforms are in fact sustained, the rate of foreign direct investment should increase markedly in the coming years.

7. Conclusion

Unfortunately, privatization of large industrial enterprises has proceeded much more slowly, indeed far too slowly. It seems clear that new methods of privatization, beyond those that have been used in the West, will be needed to speed the process. After much debate and analysis, there are plans in Poland to privatize several hundred large enterprises by giving away their shares to the Polish population. Specifically, the plan is to freely distribute a portion of the shares of these large industrial enterprises into mutual funds, whose shares in turn will be distributed to the adult Polish citizens. There is also some discussion of distributing shares into new private pension funds that would take over some of the burden of the state social security system.

The greatest risk in Poland is that populism, confusion of property rights, and a splintering of political power in the parliament, will lead to weak governments unable to take the last decisive step to private ownership. In that case, the economic situation will almost surely deteriorate, macroeconomic instability will rise and, as in Latin America, democracy itself could be put at risk. The risk is heightened by the fact that Poland has adopted proportional representation as the basis for parliamentary representation. This voting system surely increases the likelihood of weak, splintered political parties, and a government that is dependent on fragile, multi-party coalitions. Twenty-seven political parties are putting forward nationwide slates, and no fewer than 62 parties fielded at least one candidate, in the parliamentary elections in October 1991!

The key fact about economic reform is that several years must pass before the fruits of reform are widely evident. The intervening period has been called a 'valley of tears', and it may be observed in nearly every country that has undergone a radical economic transformation, from post-war Germany and Japan, to Chile and Mexico in the 1980s. The time in the valley depends on the consistency and boldness of the reforms. If there is wavering or inconsistency in economic measures, it is easy to get lost in the valley. Argentina has been lost for forty-five years.

The glue holding together the reforms is the basic social consensus that success will be achieved by 'returning to Europe'. But if western Europe

shows that it doesn't really want Poland (and the rest of Eastern Europe) to 'return', then the consensus will break apart, and the intense pressures already facing the governments of the region are likely to undermine the reforms. Worst yet, given the stingy attitude of the West to date, and the undoubted cases of rapacious Western investors intent on profiteering from the gaps in adequate legal structure in Eastern Europe, there is already an evident risk of a xenophobic backlash among part of the Eastern European population.

References

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Notes

1. This article is based on a talk delivered for the Sideman Award in International Political Economy for 1991.
2. According to World Bank estimates of dollar GNP for the year 1989, we find: Czechoslovakia, \$3,450; Hungary, \$2,590; Poland, \$1,790. This compares with Portugal, \$4,250; Greece, \$5,350; Ireland, \$8,710; and Spain, \$9,330; and in Latin America, with Brazil, \$2,540; Uruguay, \$2,620; and Venezuela, \$2,450. See: World Bank (1991).
3. Before Poland's big bang, there had been great concern about liberalizing prices in the face of a highly monopolized industrial structure. Many economists had insisted that price liberalization could only be accomplished after a substantial, and time-consuming, demonopolization of the economy. But this view was basically mistaken, since the immediate introduction of free trade was a quicker and more effective means of instilling competition in Poland's markets than an attempt at administratively guided demonopolization.
4. The British privatizations typically followed a pattern in which the firm was 'prepared' for privatization through an internal restructuring; the firm was 'valued' by one or more investment banks, to get a base price for an initial public offering (IPO); the IPO was widely advertised and promoted; and then the IPO was carried out several months later. The whole process could take a year or more.
5. This section is based on Sachs (1991).
6. Consider merely the question of the public's financial holdings, for comparison with the capital value of the industrial enterprises. The post-tax profits of the largest 500 state-owned firms are approximately \$5 billion. With a price-earnings ratio of 5, the capital value of the largest 500 firms is around \$25 billion. The public's financial holdings in the banking system total approximately \$10 billion, only 40 percent of the capital value of the largest firms at the modest P-E of 5. And taking into account that other property in addition to the 500 large enterprises is also to be privatized, it is clear that in order to privatize through IPOs, the share prices would have to be at very low price-earnings ratios, which in turn would risk a socially unacceptable concentration of share ownership. The alternatives are to transfer the shares to the public freely by some

means (as recommended below); or to sell the shares on a leveraged basis, which would pose its own risks and complications. For a detailed discussion of the concept and motivations for a free distribution of shares, see Sachs and Lipton (1990).

7. The finance studies stress that bank ownership of corporate equities tends to foster a healthy long-term relationship between the banks and the industrial enterprises, a relationship that contributes especially to a long planning horizon of the industrial enterprises.
8. The wage explosion in East Germany has had devastating consequences, for it has led to the virtual bankruptcy of the entire East German industrial sector. Most enterprises continue to operate only by virtue of large-scale subsidies from the government. Wages have risen to around 50 to 60 percent of West German levels, even though productivity is perhaps only 20 to 30 percent of West German levels. The wage explosion resulted from a variety of factors: the lack of wage controls; the East German public's belief that they 'deserved' West German wage levels; the unwillingness of politicians in West Germany to speak out on behalf of rational wage policies; and the pressure of West German unions to help raise East German wages, lest the lower wages in the East undermine the wages in the West.
9. By favorable or unfavorable I refer to the value of the offer compared to the value of the capital that is being sold to the foreign bidder. Of course, the issue of self-dealing by managers in the face of hostile takeover bids is familiar in American capitalism as well, but the managers are limited in egregious behavior by the board of directors, which is itself bound by corporate law to consider the interests of the shareholders as paramount in the event of a takeover bid.
10. Protectionist pressures will also be easier to resist if the East European countries are successful in signing Association Agreements with the European Community. These agreements should presumably guarantee open markets on both sides, and therefore bind the East European countries to free-trade policies.