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JOHN GOULD

Columbia University/Tufts University

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The most bitter pill that our nation will have to swallow is to see who will be the winners and who will be the losers in the process of transformation and privatization. The winners will certainly be the old winners and the losers will be those who were also the losers under the previous regime. Dusan Triska, Former Deputy Finance Minister and Director of Privatization in the Ministry of Finance, Czech and Slovak Federal Republic[1]

Democracy assumes that power is both given and revoked by electoral verdicts and thus routinely requires rotation in office. But if power holders have reason to fear that relinquishing power could endanger their life and property, it is clear that they will not relinquish it. Therefore until politics is 'tamed' the stakes will be too high for politicians to surrender their power and step down. Giovanni Sartori[2]

ABSTRACT

Loser-centered models of postcommunist economic reform predict that reforms will stall because of a backlash from those hurt by reform. They fail, however to predict the course of postcommunist regimes because they are based on a priori assumptions of voter preferences and societal capabilities that are better determined through empirical, path dependent analysis. Winner-centered models, by contrast, predict that reforms stall due to the influence of those who gain rents from the incomplete or 'partial' nature of early market reforms. They underestimate, however, the institutional effects of reform politics. Both approaches, moreover are pluralist and fail to account for the development of state-society networks. This paper develops a distributive conflict model of that maps the dynamic interaction between reform institutions and societal conflict. The gap between the winnings and losses of reforms shapes the intensity of political competition. Intensity of political competition, in turn, will shape a postcommunist regime's chances to consolidate democratic institutions. These concepts are investigated through a detailed discussion of the politics of reform and privatization in the Czech and Slovak Republics.

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[1] Dusan Triska, "Privatization: Czechoslovakia", *Eastern European Economics*, Fall 1991, 27.

[2] Giovanni Sartori, "How Far Can Free Government Travel?", *Journal of Democracy,* July 1995, 105.

Introduction*

In 1994, the Czech and Slovak Republics were generally considered to be among the leading candidates for early admission into the European Union. By July 1997, however, the European Commission recommended that Slovakia not be invited to the first round of talks. Above all, they blamed the "unsatisfactory" integration of Slovakia's political institutions into the "political life" of the country. Slovakia's economic performance placed it firmly among the ranks of those countries that had been selected. By contrast, the Czech Republic, shared a similar level of progress in the realm of economic reforms but clearly demonstrated the political stability that the commissioners desired.[3]

This monograph looks at the role of economic reform in the political development of the Czech and Slovak Republics and aims to provide a richer understanding of the domestic factors that led to the Commission's decision. The impression that Slovakia "got it right" economically but has been incapable of putting its political house in order is perhaps misleading. While many of the country's problems were primarily political in origin, in no Central European country have economic reform and institutional weakness been so closely linked.

The focal point of this linkage was a battle over the means and administration of privatization in Slovakia. After 1994, privatization benefits were distributed through a coherent political and economic state-society network of patronage and political influence. The result was a fusion of particularistic political and economic interests that could only be achieved and maintained by circumscribing the institutions of liberal democracy. These networks generated considerable political and economic rents. The defeat of the networks' chief patron and beneficiary, Prime Minister Vladimir Meciar, in September 1998 elections, provided his opponents with an opportunity to reduce rent seeking and reinvigorate liberal democratic institutions.

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* I would like to thank Hilary Appel, Consuelo Cruz, Sheena Singh Danzinger, Michelle Egan, Jarko Fidrmuc, Stacy Goddard, Heather Grabbe, Andrew Green, Joel Hellman, Petr Kopecky, Kevin Krause, Darina Malova, Catherine Perron, Sona Szomolanyi, Kellee Tsai, Peter Ucen, and three anonymous reviewers from the Robert Schuman Centre for their comments on parts or all of this paper. All errors and shortcomings remain my own.

[3] European Commission, "Agenda 2000-Commission Opinion on Slovakia's Application for Membership of the European Union," Doc. 97/20, Brussels, July 15, 1997, Section 1.3.

By contrast, the Czechs avoided a vicious, polarizing battle over privatization. Their success lay in their ability to establish and maintain a broad based, consensual privatization framework that cut across key social and political cleavages. While the results of privatization led to inefficiencies and rent seeking, rent winning groups were not organized into coherent state-society networks that could manipulate political institutions to protect their rents. Unlike Slovakia, privatization had few disruptive effects on the country's democratic development.

The following paper explores the politics of reform in the Czech and Slovak Republics. Part one summarizes dominant theoretical concepts for addressing the links between economic reform and democratic institutionalization in postcommunist countries. It then suggests a new approach that incorporates distributive conflict over the wealth and power of a country. Part two looks at the politics of reform backlash Czechoslovakia and helps us to explain the divergence of Czech and Slovak privatization frameworks after independence. Finally, part three compares the divergent politics of privatization in the Czech and Slovak Republics and evaluates its political and economic effects.

Part I: Effects of Economic Reforms on Democratic Consolidation

The Puzzle

For political economists nurtured on Latin American economic transitions, the rapid collapse of communist regimes in Central Europe, while exhilarating to watch, raised some difficult policy issues about how to reform an economy in a liberalizing political climate. After 1989, the region's deep, all-encompassing, and most importantly, *simultaneous*, political and economic transitions meant that analysts and policy makers alike had to consider *both* political and economic dynamics. They also had to think very hard about how they would interact.[4] Latin American experience pointed to the fundamental policy dilemma of the simultaneous transition: that there seemed to be a tradeoff between economic and political transitional goals.

The lesson inherited from previous Latin/South American transitions was that the sharp declines in consumption following the onset of trade and price liberalization and macroeconomic stabilization would lead to a political

[4] For a more detailed discussion of the differences between South American and Central/East European transitions, see Valerie Bunce, "Comparing East and South", *Journal of Democracy,* July 1995, 87-99.

backlash against reform. This was expected to be particularly sharp in a 'dual transition' where simultaneous introduction of political and economic reforms provided the groups most affected by declining consumption with the freedom to protest, strike and express disapproval at the polls. Latin Americanists thus expected that Central European political leaders would come under great pressure to slow or reverse economic reforms.[5]

Reform in Czechoslovakia did not correspond to expectations. The traditional "losers" of Latin American experience - unions, pensioners, producers for the domestic market - remained relatively quiet as real wages dropped, life savings evaporated in a burst of inflation, and foreign goods began to flood the shops. A 'backlash' of sorts occurred in Slovakia where starting conditions - particularly the vulnerability of its external markets - exacerbated the pain of transition. But then, the Slovak backlash took forms unexpected by inherited models of transition. It was directed less against reforms *per se* and more towards "external" control from Prague which did not seem to compensate for particular Slovak conditions.[6]

In hindsight, it turns out that the greatest resistance to reforms has come not from these potential losers of additional reform, but rather, from those who "won" from earlier reforms. These winners gained from the "partial" or "incomplete" reform process to "draw substantial "rents" from the rest of society. The most notable winners in the Czech and Slovak cases were the winners of privatization. In both countries, they profited from a glaring gap between the introduction of private asset ownership and the lack of necessary additional structural/institutional incentives for economically optimal behavior. This partial reform equilibrium allowed new asset holders to engage in asset stripping, minority shareholder rip-offs, and insider trading, as well as to run up huge liabilities with little threat that they would be fired by new owners or

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[5] "Loser-centered" approaches include: Lesek Balcerowicz (1995) *Socialism, Capitalism, Transformation*, Budapest, Central European University Press; Beverly Crawford (1995) "Post-Communist Political Economy" in Beverly Crawford (ed.) *Markets States & Democracy*, Boulder, Westview Press; Stephan Haggard and Robert R. Kaufman (1995) *The Political Economy of Democratic Transitions,* Princeton, Princeton University Press; Joan Nelson, "the Politics of Economic Transformation: Is Third World Experience Relevant in Eastern Europe?", *World Politics*, April 1993, 433-63; Mitchell Orenstein, *Out of the Red: Building Capitalism and Democracy in Post-Communist Europe*, Anne Arbor, University of Michigan (forthcoming); Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America*, Cambridge, Cambridge University Press, 1991, 138.

[6] John Gould & Hilary Appel, "Identity and Economic Reform: Government Strategy and Managerial Interests in Postcommunist Transition", *Europe-Asia Studies* (forthcoming).

forced into liquidation.[7] In both cases, moreover, they received at least the tacit backing of politicians who were afraid of the social costs that real structural reform would entail.

Ironically, in a perverse sort of way, the experience of the Czech and Slovak Republics turns conventional classical economic thought on its head. As predicted by economist Ronald Coase, the Czech and Slovak cases demonstrate that the means of privatization make little difference to economic outcomes. In the absence of a state that intervened to facilitate and enforce contracts, asset holders in both countries engaged in the same short-term, sub-optimal maximizing behavior.[8] Worse, in both cases, the primary beneficiaries of privatization's partial reforms fought against the adoption of additional reforms that were needed to ensure that assets would flow to where they would provide the most optimal returns. Moreover, as noted, leading politicians frequently backed them, at least tacitly, in this effort.

Problems with Models of Postcommunist Reform

The failure of loser-based reform models to predict Czech and Slovak outcomes stems from their public choice lineage. They made *a priori* assumptions about the preferences of societal interest groups that were not necessarily accurate and they overestimated the ability of these groups to translate their interests into policy outcomes. They assumed, in particular, that societal interests that had most to lose from economic reforms would be able to get their 'collective act' together, and prevail in the policy sphere. Hence, analysis of interaction between state and society, and the policy networks that structure relations between the two, as well as the possibility of *contingent* outcomes, disappeared into the theoretical concept of "collective action" and the mechanical summation of the coherence of interest groups that a cursory collective action analysis entailed.

The loser model's *a priori* assumptions of identifiable anti-reform interests and robust capacities were arguably incorrect for Czechoslovakia at

[7]Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions", *World Politics*, January 1998, 203-33.

[8] The major insight of Coase was that, given a institutional framework that enables and enforces contracts, the first distribution of property rights makes little difference to efficient outcomes. This is because the ability to engage in contracts allows asset holders to contract around inefficiencies to ensure that all opportunities to increasing returns are fully exploited. Ronald Coase, "The Problem of Social Cost", *Journal of Law and Economics*, No. 3 1960, 1-44; For a more extensive discussion of Coasian contracting in postcommunist societies, see Maxim Boycko, Andrei Shleiffer & Robert Vishny (1995) *Privatizing Russia*, Cambridge, MIT Press, Chapter 3.

the time of launching of economic reforms. First, this was a period of significant disruption in which interests and organizational capacities were in flux. Particularly at the outset of the transition, both interests and capacities were far from clear.[9] As I shall demonstrate in Part II, both preferences for reform policy and the ability of societal groups to enact those preferences in the policy sphere were *path dependent* on the trajectory of economic and political development under communism. This, in turn shaped the ability of the losers and winners of radical reform to engage in collective action to protect their interests.

Path dependent analysis, for example, reveals interests and capabilities that would predict a relatively weaker loser backlash in the Czech Republic and a relatively stronger backlash in Slovakia. In the Czech lands, a larger proportion of voters were ready to accept significant declines in real incomes in exchange for the promise of a rapid "return to Europe" while unions and managers were afraid to resist reform for fear of being tarred communist and losing their institutional and organizational privileges.

In Slovakia, by contrast, groups that were more likely to defend the material status quo and demand a state role in solving social and economic problems found an important resource in the politics of nationalism. These sentiments, and those of formerly communist managers who felt threatened by early industrial reforms and voucher privatization, aligned with local politicians to produce an economic backlash that was distinct in the region for its nationalist character: directed against *external* control from Prague and the Czech identity of the architects of reform.

I develop this argument in part II. The theoretical point, however, is that *a priori* assumptions of interest may mistakenly lead us to expect that losers will both demand a return to the *status quo ante*. Through an *a priori* analysis, we can explain why the Slovak reform backlash took the form of demands for an alternative *form and mechanism* of reform: one that would be Slovak controlled and directed less towards "capitalism without adjectives" (as Czech Prime Minister Klaus described his aims), and more towards a social market economy. We can also explain why there was virtually no significant backlash in the Czech lands. The prevalence of "social peace" was over-determined. Favourable economic conditions, and in particular, rapid job creation also helped. Stronger social policies and the popularity of voucher privatization were also factors, but since these were also present in Slovakia, must be slightly discounted as explanations for the popularity of Klaus' reforms in the Czech

[9] Mitchell Orenstein, *Out of the Red*, Chapter 1, manuscript.

lands.

The second reason loser approaches failed in the Czechoslovak case was that they took insufficient note of reform's rent seekers. In an alternative "winners approach" offered by Joel Hellman, while reforms challenge the rents earned by groups that had status under communism (workers, managers, government bureaucrats and the like), reforms also provided many of these same groups with the opportunity to earn new, and often substantially greater, rents. Launching reforms was easier to accomplish than sustaining them because these "reform winners" had something to gain both from *launching* reforms and *stalling* them before they could be fully completed. The advantage of incomplete reforms was that they allowed these reform "winners" to earn substantial rents from the market distortions that resulted. Hence black marketeers would take advantage of the new right to open a private firm to launder money, enterprise managers would use an intransparent and poorly regulated equity market to engage in asset diversion and insider trading, monopolies would use price liberalization to gain greater profits, and so on.

Hellman's approach, however, shares a number of problems of public choice analysis. It fails to explain why some market actors maximize short term profits by rent seeking, while others work to reform markets to build long term optimal solutions. It also subsumes the battle for political interest into the assumption that policy will automatically reflect the will of interest groups that successfully overcome their collective action dilemmas. Important variables like state autonomy, state capacity and state-society policy networks are thus left out.

Also important is that while the winners approach, like the losers approach, has a lot to say about politics and policy, both are ultimately concerned with explaining economic outcomes and not the consolidation of political institutions.[10] This "economics first" research program has certainly been useful. However, on normative grounds, I would echo Przeworski in arguing that dual economic and political transitions from postcommunism need dual economic and political targets.[11] Some might disagree about what these targets should be, but we do need to think harder about the ramifications of economic policy for political institutions.

[10]Przeworski does, however, warn that insulating policy makers against loser backlash has detrimental effects on the quality of democracy - and (in presidential systems) is likely to lead to, or reinforce, what O'Donnell calls "delegative democracy": Guillermo O'Donnell, "Delegative Democracy", *Journal of Democracy*, January 1994, 66; Adam Przeworski et al. (1995) *Sustainable Democracy*, Cambridge, Cambridge University Press, 80-1.
[11]Przeworski, *Sustainable Democracy*, 82

The "economic first" bias is a particular problem for the winner based approach. Hellman's empirical test of the winners model correlates postcommunist advancement in political reforms with the advancement of economic reforms. Hellman's causal story is that greater political openness allows voters and policy makers to dislodge rent-seekers. But he also assumes that winners have the power to veto additional reforms that might dislodge their rents.[12] It seems just as likely that in some cases, these winners might go the additional step and close the system off to loser dissent. This is another way of saying that political institutions both channel conflict and are the result of conflict; they are simultaneously independent and dependent variables. Economic reform therefore might, in a number of situations, explain political reform - and not only the other way as Hellman hypothesizes.

A final problem with the winners approach is that in many cases Hellman's winners are indistinguishable from the traditional losers of reform. This is perhaps more the fault of loser-based models which combine two logics of reaction to reform reflecting two separate classes of actors. On the one hand, reforms stall because reform-induced reductions in consumption lead voters to set back reformers at the polls. On the other hand, reforms threaten the rents won by 'distributional coalitions' - generally unionized workers - forcing them to "lobby, bribe, strike. . . and vote to persuade governments to allocate resources to them".[13]

Analytically, 'distributional coalitions' that seek to protect the rents they won under the former communist system are almost identical to Hellman's reform winners. Both are assumed to maximize their utility by drawing rents from the rest of society. Both have won in the past and now draw rents from the rest of society. Both are threatened by additional reforms and thus seek to stop them. Indeed, no matter what one calls them, they are both rent seekers. Voters, by contrast, need overcome no collective action problem. Rather, their disapproval of reforms is expected to be more or less automatic if it appears on election day that the path back to status quo levels of consumption will be longer by continuing reforms than by stopping them.[14]

In sum, winner and loser approaches share a number of problems in the central European context. They are overly concerned with economic development at the expense of political development. They make unwarranted *a priori* assumptions about actor preferences and their ability to engage in rent seeking; and finally, they fail to adequately distinguish between rent-seekers

[12] Hellman, "Winners Take All", 227-31.
[13] Beverly Crawford, "Post-Communist Political Economy", 4.
[14] Przeworski, *Democracy and the Market*, chapter 4.

and voters.

Towards a Distributional Conflict Model of Reform

This section suggests a research program that aspires to fill in some crucial gaps left by the dominant paradigms of post-communist political economy. First, rather than focusing on pre-defined actors, it looks at the role that state reform institutions play in shaping the incentives and challenges actors face. Yet, institutions are seen as both the partial product and the partial determinant of distributional conflict between societal and political actors. While this approach retains an implicit assumption about actor rationality and preferences, both assumptions may also be better informed by *a priori* empirical analysis (as will be shown in Part II). In addition, by focusing in on the relationship between state institutions and social and political conflict, a distributive conflict model of reform allows for consideration of the development of state-society policy networks, patronage systems and the like, that are ruled out by the societal actor-centered, winner and loser approaches. [15]

Second, the distributive conflict model attempts to demonstrate the role economic reforms play in political institutional change and democratic consolidation in postcommunist societies. It thus attempts to remedy the bias of models of postcommunist change which focus almost exclusively on the role of political institutions on economic reform.

My focus is on privatization, the capstone of structural change. This too is a departure from loser-based models - which have tended to focus primarily on liberalization and stabilization change. Despite a range of disagreement between "gradualists" and "shock therapists," the reform role assigned to privatization by political economists is relatively uncontroversial. Done correctly, privatization should ensure an appropriate supply-side response to new constraints and incentives placed on firms by a program of stabilization, liberalization and related structural reforms. Once macroeconomic stabilization reduces a firm's subsidies and increases the cost of credit; and once liberalization raises the prices of inputs, opens the economy up to foreign competition and breaks up monopolies so that they face greater competitive pressure, privatization ideally introduces owners who have the micro-incentives to manage the firm rationally in response to new price structures. They will correspondingly cut costs, introduce new technologies, and find additional

[15] For more on the politics of liberal economic reform and state-society networks see, Frances Hagopian, "Negotiating Economic transitions in Liberalizing Polities: Political representation and Economic Reform in Latin America", Working paper no. 98-5, Weatherhead Center for International Affairs, Harvard University.

markets. According to the conventional wisdom, only after this supply side response begins to take effect at the firm level do postcommunist economies experience sustainable growth and long term stability.

To enhance this response, many reformers also called for additional structural reforms that create a financial and legal institutional base for a market economy. Specifically, banks must reward winners and punish losers and not the other way around. Contracts (including those between debtors and creditors) must also be enforced and property protected. [16]

Yet even when done correctly from an efficiency standpoint, privatization can also have significant effects on political institutions. These effects are perhaps better illustrated by highlighting a few contrasts with traditional privatization programs in the West and elsewhere. While Western programs have been controversial at times, and are frequently politicized, they have not threatened to have discernable effects on the basic institutions of democracy. This is probably because of a number of significant differences in context. First, in the West, interest groups are well established, generally stable, and usually enjoy enduring and legitimate mechanisms of representation. In postcommunist societies, by contrast, both societal interests and their representation mechanisms are in states of flux. This is not to say they don't exist, but they may be disorganized by the speed of postcommunist change, compromised by their communist past, or simply stuck in a cognitive vacuum in which it's not clear where their interests lie.[17]

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[16] Despite this wide range of consensus about the role of privatization in principle, there remains great disagreement on the size, sequencing, speed and stress of reform prescriptions. By and large, gradualists prefer to delay or diminish some key aspects of privatization until other structural reforms are in place and steps have been taken to begin restructuring the firm. Radicals, by contrast, preferred to all launch reforms as quickly as possible, including as we shall see, rapidly transferring property into private hands. David Lipton & Jeffery Sachs (1990) "Privatization in Eastern Europe: The Case of Poland", *Brookings Papers on Economic Activity*, Vol. II, 293-341; Shafiqul Islam (1993) "Conclusion: Problems of Planning a Market economy" in Shafiqul Islam and Micahel Mandelbaum (eds) *Making Markets: Economic Transformation in eastern Europe and the Post-Soviet States*, New York, CSFR. A vigorous debate on speed in privatization also took place among economists in Czechoslovakia in early 1990. Compare Dusan Triska, "Privatization: Czechoslovakia", 22-7 with Otakar Turek (1990) "K aktualne problemum cs. hospodarske politiky", *Makroekonomike anlyzy a prognozy*, Institute of Forecasting, Czech Academy of Sciences, Prague, 48-67, espec. 61-2.

[17] Guillermo O'Donnell & Philippe Schmitter (1986) *Transitions from Authoritarian Rule: Tentative Conclusions about Uncertain Democracies*, Baltimore, John Hopkins 3-4; John Hall, "After the Vacuum: Post-Communism in the Light of Tocqueville" in Beverly Crawford (ed.) *Markets, States, and Democracy*, 89

Second, privatization programs in the West take place within a wider framework of consolidated democratic institutions. Postcommunist societies, by contrast, undergo a concurrent transformation and consolidation of political institutions *while* they privatize. Recent scholarship on democracy demonstrates that this process is more difficult than was recently thought. The fall of communism introduced political liberalization and established the basic institutions of democracy, but this did not automatically produce *liberal* democracies. These, it turns out are harder to craft than just having free and fair elections at regular intervals and guaranteeing basic civil and political rights. Beyond free and fair elections, *liberal* democracies ideally guarantee the universal application of the rule of law, horizontal restraints on executive power, and a conception of constitutionalism that both enshrines these two principles and makes institutional change difficult without a super majority.[18] These guarantees reduce the risks of the political game for those that lose elections and make it more likely that all groups will submit their interests to the uncertainty of democratic political competition.[19] Few postcommunist democracies, alas, enjoy the advantages of a fully consolidated liberal democracy. Indeed, there is little to guarantee that once the basic guarantees surrounding democratic elections are secured, a liberal democracy will follow.

Third, unlike privatization programs in the West which are limited in scope, postcommunist privatization programs usually transfer *the majority* of a country's economic assets to private actors. The winners of postcommunist privatization contests are destined - by virtue of the resources they receive - to play an extraordinarily important role in the future politics and economy of the country. Conversely, if one loses the privatization game, one's ability to compete in future political and economic contests will be severely diminished. Privatization is therefore a high stakes, short-term political contest for the resources of a society - one that different actors in society might be willing to go to great lengths to win.

These observations suggest an alternative approach to studying privatization in postcommunist countries, one that attempts to capture the

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[18] Fareed Zakaria, "The Rise of Illiberal Democracy", *Foreign Affairs*, November/December 1997; Guillermo O'Donnell, "Delegative Democracy"; Juan Linz & Alfred Stepan, "Toward Consolidated Democracies", *Journal of Democracy*, April 1996; Guillermo O'Donnell, "Illusions about Democracy", *Journal of Democracy*, April 1996; John Gould & Kevin Krause, "When Elections Matter Too Much! Developing Long Term Democratic Thinking in Slovakia", *Forum Obcianskej Spolocnosti*, June 1998; Kevin Krause & John Gould, "Self-Interested Generosity: A Principle for Change Towards Democracy *Between* Elections", *Sme*, November 14, 1998.

[19] Przeworski, *Democracy and the Market*, 26-34.

distributive effects of privatization of first property rights on democratization. First, postcommunist privatization occurs while social groups' interests and modes of representation are in flux and the development of political institutions uncertain. Against this background, the sheer size and value of assets involved in postcommunist privatization brings distributive issues to the fore in a manner entirely dissimilar to privatization programs in the West. Groups will organize to win this battle. Privatization is thus likely to serve as a catalyst for the consolidation of new constellations of group interests and organizational capabilities.

Nor does a democratizing setting necessarily mean that privatization battles will be fought fairly or according to a mutually agreed upon set of rules. Due to lack of consolidated channels of interest representation and the incentives to rewrite rules to one's advantage, the nascent institutions of democracy and modes of interest representation will probably be as much a by-product of this fight as an arbiter of it: if conflict over privatization institutions gets too intense, combatants will become less willing to compete within given frameworks and may seek to alter or circumvent them to their own advantage. Privatization is thus a critical juncture in the development of postcommunist political institutions.

The key to understanding these dynamics is the "privatization framework." ***Privatization frameworks are sets of informal and formal decision making rules that determine which actors get assigned first property rights, and, as importantly, which don't.*** One complication is that privatization frameworks are both the products and arbiters of conflict. A study of privatization thus implies two virtually continuous distributional conflicts: one to establish and operate privatization frameworks and a second that results from the issue of first property rights and conflict around the partial reform rents that may follow. Both conflicts are analytically likely to have similar effects on political institutions.

Privatization frameworks - and their associated institutions - are endogenous to a dynamic process of societal conflict over the distribution of wealth and power in a country. Like thermostats built of wax, they influence the "heat" of conflict. Should they fail to retain a reasonable temperature, they themselves will start lose their ability to function in the manner originally envisioned.[20]

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[20] For more on the dynamics of institutions, see Sven Steinmo & Kathleen Thelan (eds.) (1992) *Structuring Politics: Historical Institutionalism in Comparative Analysis*, Cambridge, Cambridge University Press.

Like thermostats, privatization frameworks are variable. They can be located along a spectrum of choices ranging from those that concentrate benefits among social and political interests to those that diffuse benefits among a wide range of interests. At one extreme of the spectrum is a "*focused*" privatization framework. At the other is a "*diffused*" framework. A focused privatization framework distributes benefits to a limited and concentrated group of coherent social and political interests, while a "*diffuse*" privatization framework distributes property rights relatively widely *across* social and political interest groups.

Social interests include nomenclature, managers, labor, mafia or foreign suitors for firms. Political interests include parties of a governing coalition, the ruling political party, or the close circle of cronies surrounding the executive. These societal interests bring their own "heat" to the "room" and thus will shape the structure and initial setting of the privatization framework.

By separating out social and political interests I create the following 2 x 2 matrix. Distributional conflict is expected to be at its most intense, and the dynamic feedback from conflict to institutions strongest, when a privatization framework "focuses" its benefits on limited political and social interests. It is expected to be the least intense, and the feedback weakest, when it "diffuses" the benefits of privatization across political and social interests. In between are mixed cases. Where political distribution is diffuse and social distribution is focused, we expect moderate social conflict. Where social distribution is diffuse, and political distribution is focused, we expect moderate political conflict.

The Political Effects of Conflict over Privatization

		Concentration of first property rights across social interest groups	
Partisan Correspondence Of first property rights distribution		***Focused***	***Diffuse***
	Focused	• "High Temperature" conflict • Institutional decay, • Patronage networks, • Nationalist alignments Slovakia 1993-1998	• Moderate electoral conflict
	Diffuse	• Moderate social conflict	• "Low Temperature" conflict • Institutions channel conflict, • Plural networks across rent-seeking interests • Liberal, integration-oriented nationalism Czechoslovakia/Czech Republic 1991-1998

The foundation, operation and aftermath of a "*doubly focused*" privatization framework is expected to raise social and political competition and intensify institutional stress. By giving property rights to some groups but not others in both the political and social arenas, frameworks threaten to concentrate political and economic power indefinitely in the hands of the ruling government and its allies. This shortens all actors' time horizons and raises the stakes of political competition. Indeed, a straightforward conflict over privatization decisions and their organizing frameworks may spill over to a conflict over those institutions that govern their creation and operation.

Herein lies the institutional danger of privatization. Lacking societal consensus for the first distribution of property rights, a 'doubly focused' privatization framework that serves the interests of political and economic interest groups (the insiders) is likely to lack societal consensus for the first distribution of property rights. Without consensus, liberal democratic institutions can block their attempts to appropriate first property rights. Insiders thus might seek to weaken democratic institutions while shaping the design of the privatization framework.

Moreover, the fusion of economic political power will probably also create substantial opportunities for the winners of privatization to profit further from rent seeking and political patronage. State-society policy networks are likely to develop along both lines. Again, to the extent that liberal democratic institutions threaten both rents and the functioning of patronage networks, privatization's "insiders" may attempt to weaken them.

Doubly focused privatization frameworks might help explain the emergence of brown-red coalitions of nationalists and old-communist managerial cadres that emerged in states like Slovakia and Croatia in the 1990's. Bereft of democratic legitimacy and threatened by democratic institutions, old managerial cadres turned to alliances with nationalists or appropriate nationalist ideas and rhetoric to legitimate seizing the distribution of first property rights and attendant insider privileges for themselves. Insider appropriation of first property rights and is thus accomplished though weakened political institutions and justified by the "national interest."

Doubly focused privatization frameworks can thus have international effects. Where insiders are threatened by the free and fair operation of the institutions of liberal democracy, they will resist political reforms. In addition, in the historically unique conditions of the 1990's, they will also resist integration into Western institutions - specifically NATO and the EU, which set basic liberal thresholds as a prerequisite for membership.

A second international effect is likely to be a confused or ambivalent policy towards Western integration policy. Indeed, in the doubly diffuse scenario, even competitive sectors might demonstrate anxiety about Western integration if it means respecting liberal democratic processes that can lead to pressures to redistribute property rights along more socially acceptable lines. Potentially competitive sectors might also prefer the easy gains from exploiting patronage ties for rent seeking rather than undergoing the difficult restructuring process required to become internationally competitive. Thus, while they would certainly gain from integration economically, the threats to property rights and insider privileges posed by additional steps towards a liberal democracy might lead them to resist the measures. Less competitive actors are expected be firmly against integration.

At the other extreme is a "*doubly diffuse*" privatization framework. By distributing property rights relatively widely *across* social and political interest groups, it reduces societal conflict. Distributive conflict does occur, but since the conflict is less zero-sum in nature, it is more likely to be reduced through mutually cooperative tradeoffs or side payments that, while not benefiting many actors as much as they would like, are still acceptable to most. Conflict is thus muted and more likely to be resolved within the frameworks established by the new hierarchy of political institutions.

Economically, the result is quite likely to be messy and result in many opportunities for partial reform rents. But rent seekers will neither be politically, nor socially concentrated. Rent winners will also enjoy greater security in their control of first property rights, but their ability to form patronage ties to the government will be challenged by the equal ability of interest groups seeking greater efficiency and an end to rent-seeking to countervailing ties with the government and ruling parties. The result will be less stress on the integrity of liberal democratic institutions.

In contrast to needing to adopt alternative forms of legitimacy, such as nationalism to justify the new distribution of property rights, new property owners will be more likely to form alliances based on standard material interests: Less competitive economic sectors will resist Western integration while more competitive export sector might seek to enhance the prospects of integration.

Summary

The remainder of this paper tests these concepts in the context of Czech and Slovak privatization. Part II explains why the politics of reform in early postcommunist Czechoslovakia failed to correspond to the expectations of the dominant paradigm of postcommunist reform. Rather than relying on *a priori* assumptions about societal preferences or capacity for resistance for reforms, it develops a path dependent explanation that better captures the nuance between the different reactions in the Czech lands and Slovakia.

Building on this background, Part III uses the distributional conflict model developed above to help explain the divergent effects of privatization frameworks on political institutions in the Czech and Slovak Republics. Privatization frameworks in Czechoslovakia from 1992 to 1993 (and in the Czech Republic thereafter) were doubly diffuse. They distributed first property rights across interest groups and political parties. Despite significant economic inefficiencies leading to rent seeking, the creation, defense and implementation of the frameworks was characterized by low conflict and few negative effects of democratic institutions. Challenging rent seekers in the Czech Republic similarly has been a low conflict affair, pitting party MP's against their colleagues, bankers against bankers, and industrialists against other industrialists.

Privatization frameworks in Slovakia after independence, by contrast, were characterized by doubly focused concentration of benefits. The result was high politicization and conflict. While distribution of first property rights resulted in similar economic efficiencies and rent seeking as found in the Czech Republic, the rights generally went to allies of the ruling coalition and industrial interests. This tight focus of benefits produced a closely allied triangle of state-party-industrial interests and greatly raised the political and social conflict. The creation, defense and implementation of this framework has therefore been highly contested and had negative side effects on democratic institutions.

Part II: the Path Dependence of Loser Politics in Czechoslovakia[21]

This section tests the significance of loser-centered models of economic transition from communism at the outset of reforms in Czechoslovakia. Loser-centered models are generally based upon two controversial *a priori* assumptions. First, they assume that voters' preferences are shaped by declining consumption. Second, they expect interest groups that are harmed by economic reforms to undertake collective action that will put sufficient pressure on reformers to halt or slow reforms. This section argues that both of these factors are path dependent - contingent upon specific, historically determined conditions. As we shall see, a path dependent analysis circa 1990 leads us to predict a weaker loser backlash in the Czech Lands and a stronger backlash in Slovakia. Early politics of reform, moreover, shaped the Slovak backlash in ways that make greater sense when we look at the specific legacy of Slovakia's communist inheritance.

Preferences for Reforms

By the 1992 elections, it was clear that radical reforms had greater support in the Czech lands than in Slovakia. Much of this can be explained by a straight forward loser-based scenario: while declines in output and industrial job losses were about equal in both regions, the Czech economy proved to be superior at creating new jobs. At the time of the election, Czech unemployment rate was under 3% while Slovak rate was topping 11%. A puzzle arises, however, when one looks at the nature of Slovak backlash: it was not against reforms *per se*.

[21] Parts of this section have been adapted from John Gould & Hilary Appel, "Identity and Economic Reform: Government Strategy and Managerial Interests in Postcommunist Transition", *Europe-Asia Studies* (forthcoming).

Rather it was *externally* directed - towards the Federal system, towards Prague-based reformers, and voiced in a language of political victimization by an alien political power.

That Slovak's would have a harder time managing the transition was not surprising. While the overall quality and efficiency of Slovak industry was remarkably close to its Czech counterpart,[22] the Slovak economy possessed a number of disadvantages not shared by its neighbor. First, it had been constructed largely with the defense and industrial needs of the Warsaw pact and CMEA countries in mind. Reliance on the defense industry was a significant vulnerability at the end of the Cold War. At the peak of its production in 1988, Slovak defense factories produced 65% of Czechoslovakia's military production.[23] This represented approximately 7.3% of total industrial production in Slovakia as compared to 1.5% in the Czech Lands. The Slovak defense industry directly employed 3.9% of all industrial workers. Indirect production accounted for up to 4% more.[24]

Between 1988 and 1991, the Slovak arms industry suffered a severe shock as its foreign markets disappeared. Reduced orders from the Czechoslovak military and the Warsaw Pact - which previously took up to 80% of Slovak arms exports - gave Slovak defense industries a significant shock months before then - Czechoslovak Finance minister Klaus' introduction of radical reforms.[25] Czechoslovak unemployment was first found in its defense

[22] Ales Capek, "The Split of Czechoslovakia and the Specific Features of the Slovak Economy" in J. Krovak (ed.) (1991) *Current Economics and the Politics of (ex)-Czechoslovakia*, New Science Publishers, Jericho, NY, 53; Oldrich Dedek et al. (1996) *The Break-up of Czechoslovakia: An In Depth Analysis*, Aldershot, Avebury, 54-6; John Gould, "Seeding Slovakia for Secession: The Sociological and Economic Effects of Socialist Industrialization" Paper Presented to the Annual Conference of the North Eastern Political Science Association, November 14, 1997.

[23] Zora Kominkova & Brigita Schmognerova (1992) "Introduction" in Kominkova & Schmognerova (eds) *Conversion of the Military Production: Comparative Approach*, Bratislava, Institute of Economics/Slovak Academy of Sciences 1.

[24] Karolina Mikusova, "Budgetary, Credit and Tax Policies - Their Impact on Conversion" in Kominkova and Schmognerova (eds) *Conversion of the Military Production*, 83-4.

[25] Other factors included the Western shift in Czechoslovak political alignment (prior to 1990, third world buyers still included Iran, Syria, Libya, and Iraq), a debt crisis among third world buyers; and the clear inferiority of Soviet-designed weapons as demonstrated by the Gulf War. See Danes Brzica, "Arms Industry Conversion: A Critical Part of Reform Strategy", Working Papers on Transitions from State Socialism, Cornell University, January 1996, 8; Oscar Mesaros, "Bottlenecks in Conversion," Kominkova & Schmognerova (eds) *Conversion of Military Production*, 20-21; Richard Outrata, "Conversion and Industrial Policy", in Kominkova and Schmognerova (eds) *Conversion of the Military Production*, 84-5; OECD (1995) *The Czech and Slovak Republics, 1994*, Paris, OECD, 89-90.

sector - and this too was felt most intensively in Slovakia. As production sagged, the shock to a number of industrial towns in Slovakia was significant. By the rough estimates of some Slovak economists, as many as 40-50,000 workers may have lost their jobs in military and related production.[26]

Second, with the onset of radical reforms, the shock to the Slovakia was compounded by a number of domestic demographic and industrial location problems that further raised unemployment. Czech and Slovak industry both suffered significant declines in both output and employment. Slovak machine and engineering firms reeling under defense cutbacks, suffered significantly more than their Czech counterparts, but, by and large industrial declines were approximately equivalent.[27] The crucial difference between the two economies turned out to be related to a significant Czech advantages in generating new economic activity and jobs. Factors such as a more rational location of industrial production to industrial hubs, proximity to Austria and Germany, an enormous influx of tourist revenues as Prague once again became an essential stop on the Grand Tour of Europe, and a concentration of foreign capital in Bohemia helped kept Czech unemployment low.[28]

In addition to poorer Slovak performance in job creation, Czechs and Slovaks differed in their pre-dispositions towards, and interpretations of, radical economic reforms. Distinct Czech and Slovak paths and 'patterns of extraction' from communism contributed to the distinct responses to radical reforms. By most accounts, by the time of the Munich Agreement in 1938, the Czech lands ranked among the world's most wealthy nations in GDP per capita.[29] Over the following fifty years, the Czech lands relative wealth declined so that by 1989, Czech standards of living were about on par with Europe's Southern periphery. Czechs were well aware of their general economic decline relative to the West under communism. This reflected general disillusionment with a lack of progress made under socialism[30] and created, after 1989, fertile ground for Civic Forum's July 1990 campaign slogan/pledge to prepare Czechoslovakia for a "return to Europe."

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[26]Brzica, "Arms Industry Conversion".

[27] Gould & Appel, "Identity and Economic Reform".

[28] For a discussion of comparative Czech and Slovak economic advantages that emphasizes similarities between the economies, see Gould, "Seeding Slovakia for Secession".

[29] Perhaps the most authoritative source is Dedek et al, *The Break-up of Czechoslovakia*, Part 1.

[30] Petr Pithart, "Towards a Shared Freedom" in Jiri Musil (ed.) (1995) *The Break-up of Czechoslovakia*, Budapest, Central European University Press, 201; Jaroslav Krejci & Pavel Machonin (1996) *Czechoslovakia, 1918-92: A Laboratory for Social Change*, Oxford, MacMillan Press, 192.

Slovak industrial development, by contrast, came under communism. In 1936, Slovakia's 24.5% of the population produced only 7% of Czechoslovakia's total industrial production. By 1990, this amount had risen to 28.8% - closer in line with Slovakia's then-33.7% of total Czechoslovak population.[31] Slovakia industrialization thus came late, and then was extraordinarily rapid.[32] The relative improvement it made in the lives of average Slovaks has probably contributed to the relatively greater likelihood of Slovaks to support paternalist interventions in the economy as well as higher distrust of market institutions. This may have raised the number of people who were dissatisfied with reforms.

According to polls taken in 1990 and 1991, the majority in each country was pro-reform, but the minority that had anti-reform values was larger in Slovakia. For example, a greater proportion of Slovaks (47%) preferred continued state employment guarantees (compared to 32% in the Czech lands). 34% of Slovaks (versus 9% of Czechs) agreed that unemployment should be avoided even if it would hinder or require the suspension of economic reform. Radical steps towards reform were similarly somewhat less popular in Slovakia than in the Czech lands (51% versus 60% approval).[33] In addition, Slovaks were less likely to see success under market conditions as the result of hard work (42% vs 52%) or intelligence (36% vs 53%), and more likely to see it as the result of luck (67% vs 60%), exploitation of others (59% vs 53%),

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[31] *Statisticka Rocenka CSFR*, Prague, Statistical Office, 1964, 49; *Statisticka Rocenka CSFR*, Prague, Statistical Office, 1991, 141 and 144; *Statisticka Rocenka SR*, Bratislava, Statistical Office, 1996, 33; *Statisticka Rocenka CR*, Prague, Statistical Office, 1996, 95;

[32] For more on Czech and Slovak economic development, see Radoslav Selucky, "From Capitalism to Socialism" in H.G. Skilling (ed.) (1988) *Czechoslovakia, 1918-1988: Seventy Years from Independence*, New York, St. Martins Press; Radoslav Selucky (1972) *Economic Reforms in Eastern Europe*, New York, Praeger; Ivan T. Berend & Gyorgy Ranky (1974) *Economic Development in East Central Europe in the 19th and Twentieth Centuries*, New York, Columbia University Press: Vaclav Prucha, "Economic Development and Relations, 1918-1989" in Musil (ed.) *The End of Czechoslovakia*; John N. Stevens (1985) *Czechoslovakia at the Crossroads: The Economic Dilemmas of Communism in Postwar Czechoslovakia*, Boulder, East European Monographs; Jarko Fidrmuc & Ming Xie, "Slovakia: New Country, Old Problems" (forthcoming), manuscript; Alice Teichova (1988) *The Czechoslovak Economy, 1918-1980*, London, Routledge.

[33] Richard Rose, *Czechs and Slovaks Compared: A Survey of Economic and Political Behaviour*, Studies in Public Policy Number 198, Glasgow, Center for the Study of Public Policy, 1992; Kevin Krause, "Different but not *that* Different: History and Public Opinion in the Slovak and Czech Republics", Doctoral Dissertation, Department of Political Science, University of Notre Dame, forthcoming; Krejci and Machonin, *Czechoslovakia, 1918-1992*, 208, 233-5.

dishonesty (38% vs 34%), or political connections (55% vs 52%).[34]

These differences should not be exaggerated. While Czech attitudes were indeed consistently the most, or among the most, "progressive" in the region. Slovak attitudes were not *significantly* less pro-reform. Moreover, they were frequently *more* pro-reform than neighboring Poland or Hungary.[35] Indeed, after a systematic review of Czech and Slovak polling data, Kevin Krause concludes, "Slovaks and Czechs are different, but the similarities in their opinions far exceed the differences." Krause adds that even where mean responses are significantly different, "an overwhelming share of the two populations hold an identical set of opinions."[36]

A crucial additional difference was thus how the communist experience helped shape the *interpretation* of reform in each country. Slovaks tended to link reform discussions to an ongoing divisive domestic debate about Slovak identity and Slovakia's proper relation to the federal government. Even though communists had, more or less, delivered on their promises of economic development, Slovaks tended to stress their inability in the Communist era to gain truly equal representation in common political structures based on the principle of "one nation, one vote." There was thus a marked reluctance on the part of a significant portion of Slovaks to see 1989 as a fundamental break with past practices of "Czech-centrism." Indeed, any political control from Prague remained suspect and Slovak's remained measurably distrustful in their dealings with both the Czechs and federal institutions.[37] As the next sections shows, this had a crucial impact on divergent capacities for resistance among reform rent-seekers across the two republics.

[34] Rose, *Czechs and Slovaks Compared*; Zora Butorova et al. (1992) *Aktualne problemy Cesko-Slovenska, januar 1992*, Bratislava, Centre for Social Analysis.
[35] Richard Rose & Christian Haerpfer (1994) "Mass-Response to Transformation in Post-Communist Societies", *Europe-Asia Studies*, Vol. 46, No. 1, 15, 19 & 23. Zdenek Lukas & Sona Szomolanyi, "Slovakia" in W. Weidenfeld (ed.) (1996) *Central and Eastern Europe on the Way into the European Union: Problems and Prospects of Integration in 1996. Strategies for Europe*, Gutersloch, Bertelsman Foundation Publishers, 201-24; Silvia Mihalikova, "Socio-political, Economic, and Axiological Orientation and Changes in Central European Societies" in Z. Strimska (ed.) *Report on the International Sociological Research*, Paris, CNRS, 1995-1997; Fritz. Plasser & Peter Ulram, "Measuring Political Culture in East Central Europe" in Fritz Plasser and Andreas Pribersky (eds) (1996) *Political Culture in East Central Europe*, Avebury, 22.
[36] Kevin Krause, "Different but not that Different".
[37] Butorova et al., *Aktualne problemy*.

Capacity for Resistance

Outside of elections, social preferences do not automatically translate into political outcomes. Yet select social preferences can also be converted into policy through various forms of collective action. Loser-based approaches to transition assume that those most harmed by economic reform are relatively concentrated and have the organizational capacity to coordinate their actions. This reflects a wider strand of thinking that employs public choice methodology: democratic political systems tend to over-reward well organized, rent-seeking pressure groups.

As with preferences, I would argue that the ability of interest groups to engage in effective collective action cannot be assumed *a priori*, but is contingent on prior paths of development. In Czechoslovakia, the communist era left societal modes of interest group aggregation and articulation in quite weak. A comparison with Poland helps illustrate the point. Beginning in the late 1960's and early 1970's contradictions in the design of central planning led Polish economic planners to increase imports of capital equipment from the West. The desire was to graft advanced technology onto the old system of central planning where cheaper labor costs and economies of scale would provide competitive advantages to the end products in Western markets. The system of central planning, however, worked no better with the new imported machinery than it did with indigenous technology. Polish planner's aspirations to cover their rising capital import bill though exports to the West never materialized. Poland went into foreign debt and was frequently hard pressed to meet its obligations.[38]

On several occasions, 1976, 1979-80, and 1989-89, the Polish government attempted to squeeze capital out of Polish society in order to meet its increasingly catastrophic foreign debt bill. This required combining wage freezes with price increases and reductions in worker benefits. At each juncture, and in line with theoretical expectations of loser-driven models of economic reforms, locally organized Polish workers and other groups in society responded with riots, protests or strikes. While the government restored order, in each case Polish workers largely succeeded in retaining wage levels and other benefits. In the 1980 crisis, workers linked across industrial branches to form Solidarity, a broad-based industrial trade union organized in cooperation with Poland's civic dissident movement. Solidarity was suppressed and its leaders imprisoned after the imposition of martial law in 1981, but the movement reemerged after a renewed payments imbalance crisis beginning in

[38] Sachs, *Poland's Jump*, 29-30.

1987 forced the government to search for partners that could maintain order and discipline while undertaking potentially destabilizing economic reforms.

In short, the Polish government's recurrent need to extract concessions from society produced a dynamic loser-driven polities that first strengthened civil society and eventually led to the creation of a strong, well-organized movement which could aggregate and articulate society's discontent. Ironically, Solidarity provided the communist government with a societal negotiating partner with the legitimacy to maintain a lid on social unrest as it dealt with Poland's chronic economic crisis.

Post 1989 Czechoslovak development, on the other hand, reflected the success of the communist government in repressing internal Party dissent after the August 1968 Warsaw Pact invasion. Unlike the Polish government, Czechoslovak Communist Party leaders eschewed Polish-style foreign borrowing. Thus the government never had to ask its citizens to make notable sacrifices beyond tolerating the daily routines of life under a repressive regime. The period 1969-1989 was characterized by general regime stability and a marked absence of any form of widespread, well-organized societal challenge. With the sudden intensification of civil unrest in November-December 1989, the incumbent regime had no strong partner which could assist it in regaining political order - the result was complete collapse of the regime.[39]

Following the revolution, there was a rapid proliferation of societal organization. But few of these were dedicated to the kinds of activities that would serve as channels for loser protest and those that could, frequently lacked organizational capacity or social legitimacy.[40] In Slovakia, environmental groups, the Catholic Church, and a number of underground religious movements emerged from the Communist era with the potential to organize and articulate the interests of distinct independent interest groups. But

[39] David Stark & Laszlo Bruszt (1988) *Postsocialist Pathways: Transforming Politics and Property an East Central Europe*, Cambridge, Cambridge University Press. The comparison with Hungarian development is also interesting. Austerity strategies under communism produced a number of channels through which organized societal groups could win exemption from austerity. But the shift from bureaucratic to parliamentary control after democratic liberalization weakened or eliminated these channels, leaving the first post-communist successor government, "better positioned to implement politically unpopular economic policies". David L. Bartlett, "Democracy and Stabilization in Hungary", *Europe-Asia Studies,* Vol. 48, No.1, 1996, 48.

[40] Petr Kopecky & Edwin Barnfield, "Charting the Decline of Civil Society: Explaining the Changing Roles and Conceptions of Civil Society in East Central Europe" in Jean Grugel (ed.) *Democracy without Borders: Transnationalism and Political Conditionality in New Democracies*, (forthcoming).

they were generally not concerned with issues of economic reform. In the Czech lands, Charter '77 had formed a strong, independent voice for political change prior to the revolution. But beyond the clear moral leadership exerted by its leader, Vaclav Havel during and after the revolution, this group had few links to society.[41] Moreover, despite their advocacy of building civil society as "a political project," most chartists were in fact unable or unwilling to build societal-based interest associations after 1990.[42] In sum, unlike in Poland, Czechoslovak society emerged from communism extraordinarily weak - with few societal organizations willing or able to represent the interests of economic losers during reform.

Trade Unions and employers groups were two potential exceptions. But they were exceptions which tended to prove the rule that societal organization following 1989 was weak. Both trade unions and employers groups emerged from the communist era with strong organizational legacies. Employers benefited from centralized industrial organs structured along production "branches". This easily leant itself to the creation of horizontally organized unions of employers. By fall 1990, (and then, only at the urging of government and union participants in a newly created tripartite mechanism)[43] these organizations created a Confederation of Industry at each republic level to represent their interests in tripartite talks with the government and trade unions. By February 1991, the organizations jointly delivered a "Petition to the Federal Parliament" demanding, among other things, continued subsidies, looser and cheaper bank credits and slower pace of reforms.[44]

Trade unions similarly were organized along branch lines and were aggregated at the federal level in the Czech and Slovak Confederation of trade

[41] As former Slovak Chartist, Miroslav Kusy put it: "The movement was neither mass based nor accepted from above. It comprised a limited number of Czech intellectuals who were unable to mobilize a mass civil confrontation with the regime; a virtual "parallel polis" - ghettoized from the rest of society - which fought for Czechoslovak citizens' civil and political rights without their active participation in the struggle". Miroslav Kusy , "The State of Human and Minority Rights in Slovakia," & Darina Malova, "The Development of Interest Representation in Slovakia after 1989: From 'Transmission Belts' to 'Party-State Corporatism" in Sona Szomolanyi & John Gould (eds) (1988) *Slovakia: Problems of Democratic Consolidation and the Struggle for the Rules of the Game,* New York, Columbia International Affairs Online Press; See also John Glenn (1988) "Citizens in theaters: Framing Competition and the Velvet Revolution in Czechoslovakia, 1989", Contentious Politics Electronic Paper Series, New York, Columbia University Press.

[42] Kopecky and Barnfield, "Charting the Decline of Civil Society".

[43] Peter Rutland, "Thatcherism, Czech-Style: Transition to Capitalism in the Czech Republic", *Telos*, Vol 25, No. 4, 121.

[44] "Petice svazu prumyslu CR a SR Federalnimu shromazdeni CSFR", *Hospodarsky Noviny*, February 20, 1991.

unions where they too participated in tripartite talks. Like employers unions, trade unions initially attempted to moderate the extensiveness of reforms and even submitted their own legislation to parliament for consideration.[45] Like the employers' petition, these objections were ignored by the Federal government. Nevertheless, within a reasonably short term, mechanisms had come into being that could aggregate and articulate the views of potential losers from reform.

The creation of parallel Czech and Slovak tripartite mechanisms came at least in part at the behest of the powerful ex-communist reform, or what Orenstein calls '68er', elements in the post June 1990 federal and republic-level governments. Even before reforms had begun, the post-communist democratic left felt it incumbent to copy Western European models of maintaining "social peace" during a period of rapid economic change.[46] The fact that the government had to create its negotiating partners indicates the initial weakness of society. And not surprisingly, in the Czech Republic - and, to a lesser extent, in Slovakia - it soon became apparent that the government was the dominant partner in tripartite talks. The government invariably succeeded in obtaining agreement to the lowest rates of wage increases in the region. In 1990 with inflation topping 60%, real wages declined 26% with no noticeable trade union action.[47]

But perhaps most importantly, neither trade unions nor employers had the ability to significantly shape the direction of radical reform. According to Hilary Appel, such efforts failed, at least in part because they were compromised by their communist past. While local union organizations generally supported the November revolution, the top organs of the communist peak labor organization opposed the demonstrations. The trade union

[45] Hilary Appel, "Mass Privatization in Post-Communist States: Ideas, Interests and Economic Regime Change," PhD Dissertation, Department of Political Science, University of Pennsylvania, May 1998, 11.

[46] Malova, "The Development of Interest Representation".

[47] Orenstein qualifies this assessment by pointing out that although Czech wages remained relatively low, labor in the Czech republic did achieve its 1991 goal of maintaining full or high employment. Thus the Czech and Moravian Chamber of Trade Unions was occasionally willing to accept the government's demand for strict wage restraint in tripartite talks. By this criteria, however, the Slovak Trade Union movement could be deemed to be extraordinarily weak. Indeed, the Slovaks clearly failed to achieve reasonable employment levels, yet were bound by similar wage restraints. Czech success juxtaposed with Slovak failure suggests that the Czech Trade Union movement probably had little to do with the phenomenally low Czech unemployment rates. Mitchell Orenstein, "The Czech Tripartite Council and its Contribution to Social Peace" in Attila Agh & Gabriella Ilonszki (eds) (1996) *Parliaments and Organized Interests: The Second Steps*, Budapest, Hungarian Centre for Democracy Studies, 178, 184-5. Rutland, "Thatcherism Czech-Style", 118-28.

movement underwent significant change following the revolution - leading to a dismissal of over 80% of trade union leaders and the resignation of 90% of union members from the communist party. But unions continued to be disregarded politically as retaining a communist, anti-democratic character.

Perhaps because of this, the reformed trade union movement was particularly weary about making any political alliances in Parliament - particularly with the communist and ex-communist left. This meant that it purposefully failed to develop links with its natural allies in Parliament - arguably communists, or the ex-communist formation, *Obroda*. In fall 1990, for example, despite significant Communist Party attempts to woo trade unions into its partisan fold, the Slovak Confederation of Trade Unions Assembly declared, "We are willing to cooperate with any political party or movement, but the non-partisan character of our work must not be compromised."[48]

A second fallout from the trade union's communist past was that it suffered ongoing credibility problems with its constituent members and unions. This final element hurt the most, because without collective leadership over the rank and file, the peak organization was virtually powerless in both its ability to shape legislation in Parliament or to apply the pressure on the government necessary to reach better wage and employment bargains in tripartite negotiations.[49]

Employers' associations similarly were hesitant to press their agenda. After the revolution, the revolutionary parties, Civic Forum and Public Against Violence (located in the Czech lands and Slovakia, respectively), established workers' committees in most enterprises that passed judgement on top managers. Industrial ministries also replaced many enterprise managers directly. The result was a significant turnover of top industrial managers, who, in the words of one analyst, were "sacrificed" to "symbolize a real break with the past".[50] In late 1991, the Federal Parliament added to the pressures on

[48]"Trade Unions Reject Party Activity in Unions", *FBIS*, October 15, 1990, 23.
[49] Hilary Appel, "Mass Privatization in Post-Communist States", 10-12; Mitchell Orenstein, "The Political Success of Neo-Liberalism in the Czech Republic", CERGE-EI Working Paper no. 68, June 1994; Mitchell Orenstein, "The Czech Tripartite Council", 184.; See also Peter Rutland, "Thatcherism, Czech Style"; Darina Malova, "The Development of Interest Representation". See Darina Malova "The Relationship Between Political Parties and Civil Society in Postcommunist Czecho-Slovakia" in Sona Szomolanyi & Grigorij Meseznikov (eds.) (1995) *The Slovak Path of Transition - To Democracy?* Bratislava, Slovak Political Science Association, 111-158; Rutland, "Worker's Response to Market transition".
[50] Ed Clark & Anna Soulsby, "The Re-formation of the Managerial Elite in the Czech Republic", *Europe-Asia Studies*, Vol. 48, No. 2, 1996, 300-01; In the ten Czech firms they studied, Capek and Mertlik found that the original communist-era director had been removed

managers after it passed an anticommunist lustration act that forbade top former communists from holding high positions in state-owned enterprises.

These measures left most of the old industrial nomenclature largely in place: Mid-level managers simply stepped up to replace their former bosses. Still, the personnel changes had a sobering effect. Managers who remained, both old and new, were reluctant to be seen resisting reforms - particularly in the area of privatization. As former-Klaus associate in the Federal Ministry of Finance, Dusan Triska, told one student of reform, "Managers were taken by every possible group as potential criminals, and everyone took them as representatives of the old regime."[51]

Yet managers were not ignored entirely. While keeping them out of the policy making process and ignoring their complaints about reform, then-Czechoslovak Finance Minister Klaus offered them significant benefits for cooperating with the privatization process. The original Czechoslovak privatization program provided managers with an inside advantage in the competition to determine how their enterprises would be privatized. Moreover, Triska relates how Klaus and his team traveled the country reassuring managers that voucher privatization would disperse shares so widely that they would remain in effective control of their firms. Through these concessions, the Klaus team gained the grudging support of most enterprise managers for the privatization process.[52]

While Slovak and Czech managers had similar outlooks on radical reforms, Slovak managers voiced many additional complaints about reforms that pertained specifically to them. Klaus' surprise devaluation in the fall of 1991 was especially provocative, because, they argued, it made Czech exporters more competitive in markets abroad while raising the import costs of Slovakia's primary and intermediate producers.[53] Managers also resented the ongoing influence of Prague-based trade companies that marketed their

in all ten soon after the revolution - generally to be replaced by someone within the firm, the industrial branch or the "founding" ministry. Ales Capek & Pavol Mertlik, "Organizational and Financial Restructuring in Czech manufacturing Enterprises, 1990-1995" in Barbara Blaszcyk and Richard Woodward (eds.) (1996) *Privatization in Post-Communist Countries*, Warsaw, Center for Social and Economic Research, 270; Orenstein, *Out of the Red*, 105.

[51] Appel, "Mass Privatization in Post-Communist States," chapter 6, manuscript.

[52] Appel, "Mass Privatization in Post-Communist States," chapter 6, manuscript; Orenstein, *Out of the Red*, Chapter 4, manuscript.

[53] See David Begg, "Economic Reform in Czechoslovakia: Should we Believe in Santa Klaus?", *Economic Policy*, vol. 14, 1991. Interview with Mikulas Sedlak, President, Association of Independent Economists of Slovakia (NEZES), Bratislava, Slovakia, March 12, 1997.

products abroad and pocketed the cash without paying the Slovak operations their fair share of the take. In general, they feared that Prague's control of foreign policy meant that all the good foreign contacts and direct investment would be directed to the Czech lands.[54] Finally, they were infuriated by President Havel's stance to end weapons exports - claiming that his 'moral diplomacy' made him a stooge of the Western defense interests.[55]

Yet, Slovak managers were less defenseless than their counterparts in the Czech lands. The fact that blame for growing unemployment could be directed externally - to Prague, towards Czech insensitivity, and Havel's alignment with what defense industry executives contemptuously called, the "new world order" - meant that Slovak managers could voice their criticism of reform in the language of national victimization. As this was the same language employed by national-populist politicians - a space opened up for them within the national-populist political camp.

The most important figure to take advantage of this inherent confluence of interests was three-time Slovak prime minister, Vladimir Meciar. Meciar is rumored to have traveled to Moscow in spring 1990 to represent the interests of defense producers while he was still Minister of the Interior in the first, postcommunist Slovak republic-level government.[56] After his elevation to Prime Minister of the Slovak Republic in July 1990, he chaired a meeting of 300 enterprise managers - primarily from the highly defense-oriented machine building and engineering industries - in what the Prague Television Service called "the first attempt to find a way of putting the Slovak economy back on its feet."[57]

Other group's political interests also coincided with those of industry in Slovakia. Soon after the launching of radical reforms on January 1, 1990, the Independent Association of Slovak Economists (NEZES) - founded by

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[54] Hence, managers supported Meciar's creation of a separate Slovak foreign policy apparatus to represent particular Slovak cultural and economic interests abroad.

[55] Interview with Jozef Urich, Commercial managing Director, Volkswagon Bratislava, a.s., Devinska Nova Ves, Slovakia, January 14, 1997; Confidential interview with ex-defense industry executive, Zilina, Slovakia, July 22, 1998.

[56] Alexander Duleba, "Foreign Policy of the Slovak Republic," Paper presented at the Conference on the Slovak Republic Five Years After the Dissolution of the Czechoslovak Federation, East-Central European Forum , Warsaw, November 28-29, 1997.

[57] Indeed, while VPN Chairman, Fedor Gal had been relatively contemptuous towards industrial managers, Meciar took them quite seriously from the start. See, Slovak Meeting Studies Economic Problems," *FBIS* August 17, 1990; Interview with Milan Sutovec, Chair, Slovak Writers Association, Bratislava, Slovakia, March 24, 1997; Milos Ziak, "Privatizaticia na Slovensku: Jun 1990-Marec 1994," *Domino Efekt*, February 28-March 6, 1997.

Movement for a Democratic Slovakia (or HZDS) co-founder, Augustine Marian Huska - asked the Slovak parliament to "immediately declare economic sovereignty," and called for the cooperation of economics experts to defend citizens "against the asocial and irritating Federal concept of a transition to a market economy." Huska later helped Meciar co-found his own political party and NEZES has since frequently represented industry's interests in academia.

While more moderate in tone, these sentiments were echoed by a range of Slovak political parties, most notable of which was the junior coalition partner - Christian Democratic Movement (KDH). In March 1991, KDH, goaded by its own nationalist wing, published an alternative to federal reform therapy, complaining that "The Federal scenario of radical economic reform does not sufficiently respect the specific attributes of the Slovak national economy."[58] With unemployment mounting and large production declines in Slovakia during the winter of 1991, politicians from KDH and a range of other parties competed among themselves to portray the federal program as an inflexible "Czech invention, created in the Czech environment for Czech conditions, and most importantly, inappropriate for Slovakia."[59] These sentiments were echoed in similar statements from the formerly communist, Party of the Democratic Left (SDL). All advocated a relaxation of radical reforms and other amendments that were touted as "more appropriate" for Slovak conditions.[60]

Over the fall and Winter 1990-91, Meciar increasingly embraced anti-reform and anti-federation arguments. He also took a public stand against lustration as part of his campaign to cultivate the favor of the former communist nomenclature.[61] In April 1991, he split from VPN to form his own party, the Movement for a Democratic Slovakia (HZDS). Forced from the post of Prime Minister by the rump of Public Against Violence(or VPN), Meciar took the lead in steering anti-radical reform sentiments in a national direction and fusing them to the wider debate over Slovakia's identity and relationship the Federation.

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[58] KDH, "Alternativy d'alsieho postupu ekonomiky reformy," *Hospodarke noviny,* March 19, 1991, 4.

[59] Ivan Miklos, "Economic Transition and the Emergence of Clientalist Structures in Slovakia" in Szomolanyi & Gould (eds) *Problems of Democratic Consolidation*, 60.

[60] See range of statements in *Hospodarke noviny,* March 19, 1991, 3.

[61] Indeed, when he ran the Slovak Ministry of the Interior for VPN in early 1990, far from "sweeping" the ministry clean of former apparatchiks and STB collaborators, Meciar apparently sought their support and loyalty - only to become outraged when his successor from the KDH proved a more zealous reformer. Abby Innes, "The Breakup of Czechoslovakia: The Impact of Party Development on the Separation of the State", *East European Politics and Societies*, Fall 1997, 409.

After Meciar's dismissal and resignation from the ruling party, the Christian Democratic Movement formed a new government and ruled through the elections in coalition with the rump of VPN. KDH suffered an exodus of its own nationalist members just prior to the 1992 election campaign. Having shedding their nationalists, VPN and KDH became deeply associated with federal reforms and a strong federation in voters' minds. In the June 1992 elections, they lost to more nationalist political formations in the battle to define "appropriate" Slovak solutions to the problems of economic reform and appropriate relationship to the Federation. The rump VPN (renamed ODU) did not even clear the 5% hurdle required to gain representation in Parliament. KDH also suffered a sharp rebuke.[62] Meciar's HZDS emerged as the strongest party in parliament. Importantly, he received significant support from industry.[63] Meanwhile, in the Czech lands, low unemployment, a party building effort and a well-run campaign by Klaus' Civic Democratic Party (or ODS) faction of Civic Forum; as well as the efforts of reform politicians to sell their changes to the Czech people, led to the elevation of leading reformer, Vaclav Klaus, to the post of Prime Minister.

Conclusion

The point of this section has not been to say that there was no dynamic of reform losers in early Czechoslovak economic reform. Rather, it has argued that the loser-centered model lacks the nuances to effectively gauge these dynamics. When we replace *a priori* assumptions with path dependent analysis of existing conditions, we see that it was by no means preordained that Central European society would be able to defend its entrenched interests from the disruptions of radical economic reform. Indeed, the separate Czech and Slovak paths of development reveal Czech conditions in 1990 that form a hard test case for expectations of loser backlash. First, there was a strong reserve of public support for reform as part of a wider project to "return to Europe". This was reinforced by economic advantages and policies that helped keep unemployment low even as real wages, consumption, industrial employment and output declined severely. Second, societal organizations and particularly trade unions and employers groups, were quite weak following the velvet revolution. Hence we are not surprised when we see a weak loser backlash in the Czech Republic.

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[62] All parties at some point advocated greater Slovak autonomy in dealing with the economic transition. The rump VPN party, ODU, however, was the most vociferous in defending the Federal concept of reforms. It chose this "suicidal" orientation largely in an effort to form a pro-lustration coalition that would finally take steps to "decapitate" Meciar's HZDS; Innes, "The Breakup of Czechoslovakia", 411-12.

[63] Ivan Miklos, "Economic Transition", 60.

Given path dependent analysis, one would expect Slovakia to be more of an easy test case for loser-driven models of economic reform. Due to state-directed, late industrialization, a slightly larger proportion of Slovaks were more likely to accept the material status quo and demand a state role in solving social and economic problems. While Slovaks benefited from the same social safety measures as the Czechs, Slovak economic vulnerabilities produced a high level of unemployment in a relatively short period of time. Worse, the external shocks that helped create unemployment coincided closely to (and were associated with) the concurrent, administratively-derived shocks of radical reform therapy - helping to discredit it.

Yet a crucial part of the Slovak backlash was that reform losers - particularly communist apparatchiks and industrial managers - found a resource in the legacy of thwarted national aspirations. This resource did not exist in the Czech lands. Sentiments of victimization among the Slovak electorate changed the dynamics of loser-backlash in Slovakia in unique ways. Rather than producing a backlash against reforms, the backlash was externally directed against "Czech" reforms. Those most hurt by reform found in the politics of nationalism an opportunity raise their influence. As we shall see, this had a crucial impact on subsequent interactions between winners and losers over the politics of privatization after independence.

Part III: the Politics of Privatization in the Czech and Slovak Republics

Czech and Slovak privatization frameworks - and their accompanying implications for the distribution of wealth and power across society - were "critical junctures" in the development of each state. Critical junctures are unique periods in history in which specific choices significantly shape and constrain the events that follow later. This section argues that the choice of privatization frameworks shaped the subsequent development of markets and democracy in the Czech and Slovak Republics. Distributional decisions about the social and political distribution of first property rights influenced the institutional ability of each country to resolve political and economic conflict. Privatization institutions influenced the "heat" of societal conflict over the distribution wealth and power. When this conflict became too hot - as in Slovakia - the "thermostat's" form and functionality became plastic and malleable. Where it did not - as in the Czech Republic - institutions retained their ability to regulate societal conflict.

Czechoslovakia/Czech Republic

From the final introduction of the Large Scale Privatization Act in February 1991 until the separation of the Czech and Slovak Republics on January 1, 1993, the concept and implementation of large scale privatization in the Czech lands and Slovakia was, with a few minor differences, largely similar. Following separation, the Czech program largely continued along the original path that had been already set, while in Slovakia, a distinct Slovak concept of privatization evolved in a highly contentious political environment.

Privatization as a Political Strategy

Czechoslovak large scale industrial privatization, with its heavy emphasis on citizen vouchers, was designed to be popular.[64] This was a crucial component of Klaus' wider ambition to build a strong center-right political party from the pragmatic wing of the revolutionary movement, Civic Forum.[65] Industrial

[64] The most convincing arguments for the voucher method focused on two key points. First, there was not enough cash in society to purchase Czech and Slovak firms, thus if privatization was to occur rapidly, some form of giveaway had to be employed. Second, a crucial component of privatization was to break away from "old structures" of central planning that led to persistent inefficiencies. It was essential to put assets into the hands of private owners who would take the necessary steps to make these assets perform as rapidly as possible.

[65] Writes Peter Rutland, "Klaus realized that the coupon method could create a constituency of 2-4 million voters with a vested interest in the success of the privatization program - and of his party, which was the main guarantor of its success". Rutland, "Thatcherism, Czech-Style", 114-5; In his classic 1992 article on privatization and path dependence, Stark claims that the

managers, while they remained on the defensive from the campaign of anti-communism, were similarly given something to gain from the voucher component. Most, probably, would have preferred a process of "standard" methods (particularly direct sales) or giveaways rigged in their favor. Yet, under voucher privatization they were responsible for a "base plan" of privatization which would then be weighed against competing plans submitted by other actors. Anyone - even foreigners - could submit a privatization plan. But managers' insider information and ties to industrial ministries (which would evaluate the plans and make recommendations to the Ministry of Privatization) gave them an advantage in the project design. Moreover, managers were told by the Klaus administration that if they reserved a significant allotment of shares for voucher privatization they would have a competitive advantage in the evaluation process. More often than not, this gave managerial plans an advantage over rival plans. During the project selection period in both "waves" of privatization, these base plans prevailed in well over half the cases.[66]

Klaus believed that labor would benefit through the voucher process as ordinary citizen-shareholders. He thus "rejected out of hand" pressure from social democrats giving unions any insider advantage in privatization, and employee shares in a privatization were limited to 10% and later reduced to 5%. Again, labor was disorganized and discredited during the debate over privatization and offered little resistance to the privatization program.[67] According to Rutland, the rank and file of Czech labor had already "swung solidly behind market reforms."[68]

Despite their sharp rebuke to the social democrats on employee ownership, Klaus and his team ensured that there would be something in large-scale privatization for almost everybody. These widespread benefits had an important political payoff. During Klaus' reign at the Ministry of Finance, real wages declined by over 20%. Providing voters and employers with some form of tangible gain was thus an essential element of Klaus' political strategy. As the results of the June 1992 elections clearly demonstrate, Klaus' new party

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choice of vouchers was enabled by the unique path of Czechoslovak development. The weak society and weak state inherited by reformers provide the freedom and incentives to use the market mechanism to transform and privatize the economy. In turn, they hoped that the voucher system would accomplish help "achieve" a market in a way that would be "*self-legitimating*". Stark & Bruszt, *Postsocialist Pathways*, 102-3.

[66] Orenstein, *Out of the Red*, 115-23; Rutland, "Thatcherism, Czech-Style".

[67] Appel, "Mass Privatization in Post-Communist States", 106-8.

[68] Rutland, "Thatcherism, Czech Style", 120-1; Appel, "Mass Privatization in Post-Communist States".

(ODS) obviously gained from this widespread support for privatization in the Czech Republic. Moreover, voucher privatization was also the most popular aspect of the federal reform program in Slovakia.[69]

Privatization's Partial Reforms

While spreading the initial benefits of privatization created a wide consensus in favor of privatization and rapid reform, the management and results of privatization eroded this consensus. Increasingly, the winners from privatization were concentrated into a smaller circle of politicians, industrial and financial managers, all of whom, supported delayed additional change while they reaped the political or economic benefits of partial privatization reforms.

a. Ideological Context: These interests were given an ideological boost from the unwavering principle of the Klaus administration to allow market actors to do most of the "heavy lifting" of reform. Klaus and his entourage - frequently citing Hayek - argued that they did not have, nor could they reasonably be expected to acquire, the insider, proprietary knowledge required to restructure firms.[70] They felt that a concerted industrial restructuring policy was, therefore, hopeless in the face of poor capacity and insufficient information. This information gap could be crossed, however, by allowing decentralized, impersonal competition among market actors to compete in an environment conscientiously devoid of formal rules.

While the need for formal rules might, in hindsight, seem apparent, Klaus and others in the Ministry of Finance felt that they could not possibly address these needs before they arose. As market actors relentlessly pursued their self-interest, they would provide themselves with rules. Rather than "gumming up the works" with strong legal frameworks for competition, they chose to instead to "run ahead of the lawyers."[71] To employ more of their imagery, the intention

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[69] Dedek et al., *The Break-up of Czechoslovakia*, 201.

[70] As Klaus argued, "no planning, organization, modernizing, restructuring, dividing and demonopolizing functions should be initiated from above." Vaclav Klaus, "An Economic 'Ten Commandments' for the 21st Century", *The International Economy*, September/October 1993. From 1990 to 1992, Klaus faced stiff opposition in this policy from federal Minister of Industry, Jan Vrba, a former industrialist, who saw his Ministry's function in exactly these terms. For a more complete discussion, see, "Mass Privatization in Post-Communist States", Chapter 6; See also Stark & Bruszt, *Postsocialist Pathways*, 154.

[71] One exception was restitution. Klaus, Triska and his entourage in the Ministry of Finance felt that giving property back to the original owners made little sense. Chances were the original owners would not be know much about the business and Klaus foresaw long delays while restitution claims were settled in the courts. This indeed turned out to be the case as

was to "turn out the light" and allow the destructive impulses of markets to do the dirty work.[72] When the light came back on, their expectation was that they would find lean and competitive economic actors. The key was to transfer property as swiftly as possible from the state to new owners so that these decentralized decisions could start to be made.

As one Ministry of Finance official summarized, voucher holders and others were given an opportunity to make some money - not guaranteed an outcome - if they got hurt, well at least they'd had a better chance than they would have had the system been set up by the insiders. Hence, like life in the wild, this was never expected to be a fair or particularly nice process, only one more efficient than a gradual, state-run transition, in which the Ministry of Industry and others fixed up firms through bureaucratic micro-management.[73]

b. Cross-ownership: In practice, however, the end result of the Czechoslovak privatization concept - with its heavy emphasis on the voucher - was neither fair *nor* necessarily more efficient than state-directed transition concepts.[74] The Czech voucher give away was initially intended to create an Anglo-Saxon-style, broad-based shareholder class. Yet as the deadline for voucher registration approached, a disappointing number of Czechs or Slovaks were willing to pay the 1000 CSK administrative fee necessary to get a voucher booklet. This changed when a number of financial intermediaries aggressively began to offer voucher holders a fixed payment of 10-15,000 CSK in one year in exchange for the right to their investment points. The voucher program

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dozens of State owned enterprises languished while awaiting a restitution decision. Triska, "Privatization, Czechoslovakia;" Interview with Vladimir Rudlovcak, Deputy Minister of Finance (in charge of capital markets regulation), Ministry of Finance, Prague, Czech Republic, July 24, 1997.

[72] As Klaus emphasized, "Transformation privatization in my country is over, but we are under political as well as academic criticism that by privatizing we have not succeeded in forming an optimum property rights structure. The ambition for transformation privatization was not to be the end of property rights restructuring but, on the contrary, to be its beginning. The task of government at that moment was to find the first private owners, not the final ones. This fundamental difference tends to be misunderstood. (Partly because it reflects the belief in the potency of government intervention and disbelief in the spontaneity of the market.)" Klaus, "The Ten Commandments Revisited".

[73] Interview with Rudlovcak, July 24, 1997; Milada Vachudova, "Democratic Consolidation in Eastern Europe: The Influence of International Factors on The Czech Republic" Paper presented to the Democratic Consolidation Project, European University Institute, Fiesole, Italy, 24-25 April 1998; Appel, "Mass Privatization in Post-Communist States", Chapter 6.

[74] Indeed, some of the Czech and Slovak Republic's greatest transition success stories are firms that were privatized through ministerial direction, Appel, "Implementation and the Ideational Context".

quickly went from too few subscribers to too many.[75] A problem from the point of view of the Klaus team was that these financial intermediaries appeared poised to gain an enormous ownership stake in the privatized economy through their investment privatization funds (IPF's).

According to one disputed report, Klaus soon realized that though the IPFs, relative outsiders and unknowns could gain enormous control over the economy. His response was to encourage *state-controlled financial institutions* to set up rival funds. Klaus's Deputy Minister of Finance, Vladimir Rudlovcak, denied this.[76]

Whichever the reason, as a result of heavy competition among independent and bank funds for voucher points, citizens invested over 74% of their voucher points in the first wave, and 64% in the second, with funds. Of this, the five bank and insurance-owned funds - all ultimately answerable to the government through the National Property Fund and their ties to the Ministry of Finance and Czech National Bank - took 41.4% of voucher points in the first wave and 18.8% in the second wave.[77] All told, the six largest IPFs controlled 65% of the vouchers. IPFs were, however, limited to a maximum 20% stake in firms. But through a complex series of interlocking holdings through informal ties with other shareholders, or shares in daughter or parent firms, IPFs were often able to control much larger blocking or controlling stakes in firms.[78]

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[75] Indeed, the Ministry of Finance did not have enough voucher booklets to meet last minute demand and the voucher registration deadline had to be extended.

[76] Peter Holub, Jan Machacek. Vladimir Mlynar, "Kde se stala chyba," *Respekt,* June 23-29, 1997, 26. A Ministry of Finance official in charge of capital markets, Vladimir Rudlovcak asserted, by contrast, that Klaus were positively impressed by Viktor Kozeny, the 27 year old Harvard graduate who set up Harvard Investment Fund - one of the first non-bank IPF's. He continues however, that he believes Kozeny and others "by no means" saved the voucher scheme by introducing their offers. Interview with Vladimir Rudlovcak, July 24, 1997.

[77] Perhaps the best and most far sighted work on this topic remains Karla Brom & Mitchell Orenstein (1994) "The Privatised Sector in the Czech Republic: Government and Bank Control in a Transitional Economy", *Europe-Asia Studies,* Vol. 46, No. 6, 893-928; Three years later, the basic issues raised there still remained. See also Kristan Palda (1997) "Czech Privatization and Corporate Governance", *Communist and Post-Communist Studies*, Vol. 30, No.1, 90; Peter Kenway & Eva Klvacova (1996) "The Web of Cross-ownership Among Czech Financial Intermediaries: An Assessment", *Europe-Asia Studies,* Vol. 48 No. 5, 797-809. Pavel Mertlik, "Czech Privatization: From Public Ownership to Public Ownership in Five Years?" in Blaszcyk and Woodward (eds) *Privatization in Post-Communist Countries*; Michelle Egan, "Joining the Club: Czech Reforms, Institutional Adjustments and Market Governance," American University, June 1998, manuscript.

[78] Amendments to the law on Collective investment in 1996 issued even tighter restrictions on IPFs with the intention of forcing them to behave more like portfolio funds and less like owners. Kenway & Klvacova, "Cross-ownership", 805.

Indeed, given the dispersion of ownership resulting from the voucher method, a 20% holding, or even less, was frequently sufficient to retain the controlling share.

As a result, a more German (or "Rhineland") form of corporate governance replaced the Anglo-Saxon shareholder concept. Financial institutions gained a major, and even controlling, stake in companies that were also their debtors.[79] But the similarity to German corporate governance structures was in form only. As David Stark and Laszlo Bruszt emphasize, this interlocking triangle of debtors, creditors and government officials ideally should have provided a network of liability and asset relations in which the key transition actors - debtors, creditors and equity asset holders - could have coordinated their resources and information to develop long term strategies of debt reduction, new investment, and concerted programs for firm restructuring.[80]

But this did not happen. Instead, despite a quite successful and promising anti-bankruptcy policy that kept firms afloat and employment high while they were being privatized,[81] the Klaus administration refused to adopt any policies of coordinated enterprise restructuring. Added to the administration's associated unwillingness to regulate or even effectively monitor competition in the new capital markets, it promoted a loss of nerve and vision among Prague's new entrepreneurial and financial class. Rather than seeking long term enterprise restructuring solutions that would benefit all, transition actors realized that if they did not act aggressively to win the easy, short term benefits that such an environment allowed, somebody else would. The results were disastrous. Instead of foregoing short term gains in a long, coordinated restructuring program, bankers loaned to captured markets; debtors borrowed money they could not repay; managers stripped assets; and funds ripped off minority shareholders.[82]

The overall lack of a governmental vision of concerted restructuring was exacerbated in its effects by a number of unsightly conflicts of interest that the Klaus regime conveniently ignored. There was supposed to be a formal "fire wall" between bank and fund management, but in practice this was ineffective. In a number of cases, bankers and fund managers combined their proprietary knowledge of firms to engage in insider trading. Nor was there any legal

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[79] Egan, "Joining the Club" manuscript.
[80] Stark & Bruszt, *Postsocialist Pathways*, 153-63.
[81] OECD (1994) *The Czech and Slovak Republics*, 87-92.; Filip Korinek, "The Privatization: Insolvencies/Bankruptcies Market", American Embassy, Prague, Czech Republic, May 1994,
[82] Egan, "Joining the Club"; Vachudova, "Democratic Consolidation."

stipulation against it.[83] A more fundamental problem was that bank managers (and the politicians linked to them through state ties) feared that restructuring enterprises would lead to "large-scale bankruptcies and massive loan write-offs." Hence, "the banks propped up inefficient industries with easy loans, refusing to cut off the flow of cash or force these firms to restructure."[84] The unwillingness to restructure was reinforced by an intentionally weak bankruptcy framework that left creditors waiting for months and even years for a court date and left debtors with many means by which to win a stay of execution.[85] Not surprisingly, the years 1994-1997 were characterized by mushrooming enterprise debt and a rise of uncollectable assets on bank and firm balance sheets.[86]

Yet the Klaus government proved unable or unwilling to privatize the banks. Purportedly, they feared the effects that more disciplined management (assuming foreign participation in privatization) would have on enterprises. Under this explanation, Klaus did not want to risk a chain of insolvency with inevitable slow-downs in production, non-payment of wages, or worse, rising unemployment, prior to the 1996 elections.[87] But the government also found that given the banks' poor lending discipline and doubtful loan portfolios, foreign investors were uninterested in buying into them or taking the heat that genuine restructuring would incur.

Indeed, five years after the fall of communism, many enterprises in bank fund portfolios remained as dependent on "soft loans" as they had been on "soft subsidies" under communism. The form of finance had changed, but firms still enjoyed a "soft budget constraint" that allowed them to avoid the hard and brutal realities of markets. While the government may not have used its

[83] OECD, *The Czech and Slovak Republics, 1994*, 86.

[84] Egan, "Joining the Club"; Joseph E. Stiglitz, "Comments on 'Czech Republic: Capital Market Review Report,'" Ministry of Finance, Prague, Czech Republic, May 9, 1997 (Thanks to Heather Grabbe for uncovering and sharing this very useful memorandum).

[85] Bruszt and Stark demonstrate how at the early stages of reform, the Klaus administration took full advantage of these reforms to avoid chains of bankruptcy during both the 1992 election and the first wave of voucher privatization. Unfortunately, despite - or perhaps, in part, because - of these promising and constructive early steps, this 'temporary stay of execution' was not used for effective restructuring. *Postsocialist Pathways*, 153-63; Korinek, "The Privatization Insolvencies".

[86] An additional problem was the dominance of the four largest banks in the Czech economy. By using their funds to retain a captured market depriving smaller competitors of deposits and loan markets and allowing them to charge higher discounts on loans. See Jarko Fidrmuc & Andreas Worgotter, "Czech banking Sector: Reasons of Banking Crises and Prospects," Internal Document, Institute for Advanced Studies, Vienna Austria, January 1998.

[87] Egan, "Joining the Club," manuscript.

influence over the four largest banks through the FNM to enforce this, neither did it take steps as primary owners to ensure banking discipline.[88] To the extent that such benign neglect kept unemployment down prior to the 1996 election, Klaus was the primary beneficiary of financial sector partial reforms. Yet since then, bank share prices have plummeted and it now appears that the government will be able to get a fraction of the price from foreign investors they could have two years ago.[89]

There was some speculation that cross-ownership might have provided a soft landing for the Czech transition - floating inefficient Czech firms long enough to allow a more efficient Czech private sector to prepare the way to take up the slack during their eventual, inevitable restructuring or liquidation. The reality however, now appears to have been that financially sound enterprises faced much higher rates for credits - this, in turn, reduced investment and the growth of the efficient private sector.[90]

c. Equity Markets: While cross ownership was a large problem, also troublesome was the Klaus administration's ineffectiveness at regulating new markets. Nowhere was the Klaus administration's willingness to let the market supply its own regulations more apparent than in Prague's nascent equity markets. Created in 1993 to handle the trade in corporate shares, the Prague Stock Exchange soon developed into a nightmare for minority shareholders. The high dispersion of shares and the multiplicity of formally and informally interconnecting funds often made it difficult to know who really controlled a company. This was dangerous for minority shareholders. In a common worst case scenario, a particularly unscrupulous fund or investment company would quietly gain majority control of a company or a investment privatization fund, shift the assets to a new legal entity (or simply sell off the assets and pocket the cash) and leave the minority share-holders with an empty shell. Within two years, such practices had virtually driven speculative foreign portfolio capital from the market while "robbing" many unwary individual voucher investors of their initial gains.

[88] Indeed, Capek & Mertlik found little evidence of direct political pressure on banks in decisions involving ten Czech firms, Capek & Mertlik, "Organizational and Financial Restructuring".

[89] The share price of Komercni Banka and Ceska Sporitelna, the country's first and second largest banks, have plummeted from 2,085 Kc to 333.10 and from 312 Kc, to 83.97 Kc respectively between December 1996 and December 1998. Ron Leuty, "CS Woes Bind Banks to State, Industries", *The Prague Post*, December 9, 1998.

[90] Palda, "Czech privatization", 92-3.

This practice of "tunneling" was exactly the sort of market behavior Klaus' team in the Ministry of Finance might have expected had they thought it through.[91] Indeed, given the inability to rationalize assets and liabilities without a working bankruptcy framework, it actually made some microeconomic sense for a manger - saddled by unmanageable debt and unable to settle the obligations legally - to strip out productive assets, leaving a debt shell to sit indefinitely on the creditor's books as an uncollected "receivable."[92] Yet, under Klaus' "regulator-light" conception of capital markets, the creditors got no share in the productive assets that were carved out or sold off. Worse, the quasi-legality of tunneling and high levels of public loathing (many voucher holders - disparagingly referred to as "small change shareholders" - were, after all among the primary victims), forced the primary culprits to take their liquid assets abroad or "launder" them through purchases of luxury items that were often imported from abroad. The Ministry of Finance, was typically unwilling and later incapable of stemming this flow and indeed, often did not see it as illegal.[93]

Most funds appeared guilty of some form of tunneling. As the World Bank's Joseph Stiglitz noted, the discounts attributed to management of Czech funds are "by far the largest in the world. . . . What is remarkable about the Czech funds is that managers are seen as taking away 40% to 80% of value. Such subtractions from value are clear market statements concerning. . . tunneling. . . No other convincing explanation of discounts of *these magnitudes could be presented by anyone.*"

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[91] Many market insiders will tell you that they did think it through. They like to point out that the brother of Dusan Triska, the primary architect of voucher privatization, is a top executive in one of the funds responsible for abuse of minority share holders.

[92] Vachudova argues that the regulatory, banking and managerial and talent simply was not there to manage such a complex transition, Vachudova, "Democratic Consolidation," manuscript. Mertlik and Capek, as well as World Bank official Joseph Stiglitz, by contrast, point to higher estimates of managerial capability. This view emphasizes instead, poor institutional incentives for optimal market performance and occasionally uses these immoral but often well executed diversions of assets to demonstrate what a clever manger can do under difficult restraints. Capek & Mertlik, "Organizational and Financial Restructuring", 281-283; Stiglitz, "Comments".

[93] The Ministry of Finance's capital markets regulation team under Rudlovcak saw the primary purpose of the capital market largely as a forum for concentrating ownership - by fair means or foul. To their credit, however, they did go after some of the more obvious cases of fraud. But then with only 30 staff and virtually no financial expertise among the police, felt they were understaffed. Interview with Rudlovcak, July 24, 1997. Rudlovcak resigned after he apparently approved the transfer abroad of over $US 30 million in assets from the CS Funds - effectively cheating over 45,000 investors of their assets. One month earlier a similar scandal hit the Trend investment fund. Terrence Petty, "Czech Republic: Investors Worried as Swindlers Outwit Regulators", *Associated Press*, April 14, 1997.

In addition, Stiglitz pointed to the new phenomenon of "Huge decreases in market value when an individual achieves market control." Economic theory, Stiglitz added, predicts that the emergence of a dominant shareholder will guarantee someone is there "monitoring and ensuring good performance." In most markets, this will invariably lead to an increase of share value. Yet in Czech markets, it had exactly the opposite effect! Stiglitz argued that the most likely explanation is that when a fund or a firm is taken over, minority shareholders can no longer be sure that their shares will be of any value and will dump the shares before the new owners strip the company or fund of its assets.[94] While bank-owned funds had lower discounts than non bank funds, they were still large. In the light of a number of arrests of officials in the banking community in early 1997 for various forms of fraud, Stiglitz concluded that banks also engaged in various forms of asset diversion at shareholder expense.

Except for a few, stable blue chip companies, the stock exchange was largely illiquid. Nobody launched an IPF to raise capital, the control issues made that too risky. Rather, they borrowed money at rates made exorbitant by a Central Bank that was trying to maintain an increasingly weak Czech Crown - and also by competition from the firms owned by bank funds which often got loans irregardless of their ability to repay. Borrowing from foreign banks was cheaper for credit worthy firms - but given the growing exchange risk - remained an option only for exporters. Some large utilities and manufacturing firms issued securities - but given the illiquidity of the Prague financial markets, increasingly chose Frankfurt or Vienna.

The primary practical purpose of the Czech capital market, therefore was to provide a forum for the rationalization of the ownership patterns resulting from privatization. Ideally, the damage done to minority shareholders was to be recouped by new owners in clear and secure control of their firms that would begin to restructure their firms. But this did not happen. The new owners frequently remained incapable of bringing sufficient managerial talent and new capital to bear on firm restructuring and remained more concerned with maximizing their short term benefits through insider trading, tunneling or asset stripping than restructuring firms. For the better part of the last four years, a significant portion of "privatized" firms have languished.[95]

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[94] Stiglitz, "Comments".

[95] According to the World bank, the net profitability of Czech Enterprises decreased from 8.0% of GDP in 1994 to 4.6% in 1996. World Bank, *Slovak Republic: A Strategy for Growth and European Integration,* Washington, DC, World Bank, 1988, 35.

Dislodging the Winners

Much of the conflict over partial reforms occurred between a narrow circle of economic and bureaucratic actors. There were two broad-ranging and interrelated debates: First, what to do about the capital market? Second, what to do about bank privatization and cross-ownership? In both debates, the arguments employed tended to be couched in technocratic language about what was and was not possible, rather than in the language of interests.

A number of cleavages, developed. However, partial reform winners sought to retain insider advantages and shamefacedly defended the unregulated, spontaneous character of the market while finding reasons to delay the privatization of banks or divestiture of bank cross holdings. Partial reform losers sought to give the market greater transparency and minority shareholder protection and tended to be more likely to favor quick bank privatization with foreign participation and potentially, steps to separate banks and bank funds.[96] This latter group tended to emphasize the need for a regulatory Securities Exchange Commission, guarantees of minority shareholder rights, and emphasized other steps to create a "more regular" capital market. Many of these suggestions were best articulated by former Klaus associate and president of the Prague Stock Exchange, Thomas Jezek. Jezek was backed by an increasingly coherent and vocal lobby consisting of a number of funds, foreign brokerage houses and banks.

Partial reform winners, on the other hand, found an ally in the ideologically-laced arguments of Dusan Triska, the head of RMS systems[97] and the co-architect of the voucher privatization and the Klaus reform scheme. Despite his private sector role, Triska remained a close Klaus associate and enjoyed Klaus' support as well as that of Klaus' First Secretary of the Ministry of Finance in charge of capital market regulation, Vladimir Rudlovcak. Triska could also count on at least the tacit support of a range of funds and enterprise

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[96] The primary argument against greater regulation was that it would slow consolidation of share holding. Rudlovcak argued that a stipulation that purchasers of a majority share would virtually stop trading. He argued for the creation of a new, regulated market, consisting of the 20 or so blue chip companies that regularly paid dividends that would exist alongside the current "wild" system. As firms got their financial house, they could go to the new formal market where they would pay dividends to protected minority shareholders. Interview with Rudlovcak, July 24, 1997.

[97] RMS Systems is the company that controlled the computerized trading of the non-paper shares that had been made necessary by the overnight creation of millions of shareholders. It Director is Dusan Triska, one of Klaus's original team of privatization architects and a strong opponent of equity market regulation.

owners that had quietly benefited from insider deals and tunneling.[98]

While these arguments played themselves out amongst a small circle of market and bureaucratic and parliamentary actors in the financial press, the political opposition began to launch a wide range of critiques of the Klaus-style of transition. These critiques ran a gamut of demands - from calls for rapid bank privatization and market regulation by Klaus' coalition partners and some politicians within his own party, to demands (by academic opposition from social democrats of the '68 gradualist school) for re-nationalization of enterprises and a gradual state-administered re-privatization.[99] These voices of dissent combined with public dismay over privatization-related government and market scandals,[100] and the beginnings of an economic slow down, to generate a particularly weak showing for Klaus' ODS in the June election of 1996 and the necessity to form a minority government in the face of a resurgent left.

By 1997, it was becoming increasingly clear that the system of ownership and government oversight that had emerged was harming the Czech Republic's macroeconomic stability and microeconomic turnaround. A run on the Czech crown and a sharp devaluation led the CSSD to attempt a vote of no-confidence in the governing coalition, which Klaus won by a single vote; a vote he got only after publicly committing himself to submit his bank privatization plans to Parliament for discussion and a vote. Klaus also fired his leading capital markets regulator, Rudlovcak - indicating a shift in market regulations in favor of the Jezek camp. Indeed, by the following year, Jezek ally Jan Muller had the parliamentary go-ahead to set up a Securities Exchange Commission.[101]

Yet the (at least temporary) coup de grace to Klaus-era partial reforms came after a party financing scandal led to the resignation of the Klaus government. Klaus was replaced by the caretaker government of Josef Tosovsky which allowed greater market regulation and tried to prepare the way for an eventual solution to the bank mess.

The development and defense of the Czech Republic's "partial reform equilibrium" has caused the country considerable economic damage and will

[98] Interview with Jan Muller, Custody Manager, Commerzbank, Prague, Czech Republic, June 17, 1997; Interview with Jiri Sebanik, Senior Manager, International Organizations Division, Czech National Bank, Prague, Czech Republic, July 25, 1997.
[99] Lubomir Mlcoch, "Did Privatization Really Take Place? The State Should Renationalize and Reprivatize Companies", *The New Presence*, July 1997, 8-9.
[100] For a good review of Czech privatization scandals, see Orenstein, *Out of the Red*, Chapter 4.
[101] Interview with Jan Muller, June 17, 1997.

continue to have significant negative effects into the foreseeable future. Yet, it has threatened the democratic consolidation of political institutions only at the margins: the corruption associated with privatization and ownership consolidation has undermined confidence in markets and produced a light pro-statist backlash.[102]

Privatization initially rewarded almost everyone. But for voucher-holders these winnings were thinly spread and short lived. By 1996-7, macroeconomic fundamentals led to a devaluation and economic slowdown that clearly edged tax payers into the loser bracket. Some managers and employees still gained from lose bank credits and a reluctance by fund owners to restructure. But as many or more managers suffered from the high cost of credit that kept their marginally successful operations from fully restructuring. Interests among bank and market actors were similarly split between themselves.

Perhaps as important is the fact that even those groups that continued to gain from partial reforms, only did so marginally. Over the past two years, it has become increasingly unclear whether the gains outweighed the losses. Indeed, winners may wish to hold on to their entrenched positions, but the alternatives offered by the challengers are not that drastic and might even profit them in the long run. Thus, on the whole these preferences are lightly held. This in turn has had a soothing effect on political competition.[103]

In the election of 1998, these splits had led to a consensus among virtually all informed parties that the partial reforms of the Klaus era had to go. And while there was little consensus on what would replace it, the broad agreement contributed to reduce the stakes of the election. The result of the election, however, was a somewhat pyrrhic electoral plurality victory for the Social Democratic Party. The largest vote in the elections went to the Social Democrats, but they were unable to form a majority government. CSSD leader, Milos Zeman, finally astounded observers by agreeing to form a minority government with the silent support from Klaus's ODS. This, in turn, provided ODS the leverage to reduce the CSSD's ability to raise social spending to

[102] As Kevin Krause points out, the Klaus years have brought Czech popular attitudes towards the role of the state in the economy and related issues, more in line with Slovak patterns, Krause, "Different but not that Different".

[103] While many gained their position by working around or at the margins of the law, by 1997, these individuals were being prosecuted where found and were on the defensive. All parties appeared guilty or potentially guilty of clientalism and corruption. Indeed, most foreign market actors will attest that corruption still runs rampant in the Czech Republic. But the gains of clientalism and corruption have not been tightly linked to any one party. Indeed, it is doubtful that a loss at the polls by the associated party of any of the groups is perceived as much of a threat.

assuage some of the pain of additional reforms. The result appears to have been a loss of political courage as CSSD necessarily has been forced to move cautiously and indecisively to address the Czech Republic's mounting economic problems without significant cooperation from Klaus's center right party, ODS. It appears likely that this configuration of interests will guarantee that additional market reforms will be gradual and threaten no single group's vital interests.

The Slovak Republic

The Slovak privatization framework diverged significantly after independence on January 1, 1993. The lion's share of large scale industrial privatization (between 1994 and 1998) was conducted under a "doubly focused" framework on behalf of top managers and politicians allied with Prime Minister Meciar. Concentrating benefits in this fashion led to greater conflict over centers of authority that could prevent it. In relatively short order, Meciar succeeded in undermining and weakening these centers of authority as well as endangering constitutionality and undermining the rule of law. Privatization also helped build and reinforce tight state-society networks of patronage. These networks mobilized the resources and policy instruments of the state to acquire new wealth and power by drawing significant rents from the rest of society. As in the Czech republic, rent seeking was both political and economic: industrialists lined their pockets while Meciar reaped the political benefits of delaying the restructuring of firms avoid restructuring firms. Clientalism and weakened democratic institutions led the European Commission to deny Slovakia an invitation to the first round of EU accession negotiations.

As we shall see, dislodging the winners of partial reforms is an ongoing, two stage process: The first stage, dislodging the Meciar's government from control of the political economy of Slovakia, was accomplished by the electoral victory of his opposition parties in the September 1998 election. The second stage, dislodging the winners of partial reform rents, is an ongoing process. It will be greatly facilitated, however, if the current coalition government can restore and improve the institutional framework so badly damaged by the Meciar years. This should help the new government to resist incentives to develop rent seeking networks of its own.

The Evolution of Slovak Privatization after the First Wave

The Slovak "concept" of privatization took two years after independence to crystallize into its eventual "doubly focused" form. Following the 1992 electoral victory of Vladimir Meciar's Movement for a Democratic Slovakia, the new government called for an economic program based on a "social market economy" with a heavy emphasis on state guided industrial restructuring and a more relaxed fiscal policy. Meciar had already formed a loose alliance with Slovak managers prior to the election (see part II).[104] Having faced relatively greater transition challenges than their Czech counterparts, and less threatened by dismissal - the force of which was blunted by Meciar during his first regime - Slovak managers took an aggressive stand demanding a greater industrial role in transition. Their position found little initial resistance among an electorate concerned about an unemployment rate thrice that in the Czech lands and among whom there was, in any case, greater sentiment for a paternalist state role in the economy and less fear of a communist backlash.[105]

Vouchers and the corresponding confusion in ownership relations made little sense to employees, managers and politicians bent on adopting some form of industrial policy. During the first two years of Slovak independence, the experience with IPF's in Slovakia - similar to that in the Czech Republic - was producing great tension within firms. After the first wave of privatization, many older, communist-era Slovak managers found themselves confronted with new owners who had no experience in industry, were generally younger and better educated, and often felt disdain for old management as hopeless throwbacks to the communist era.[106] There emerged a distinct generation and ideology gap between funds and enterprise management. This gap was further widened by early reports of market shenanigans associated with voucher privatization that plagued Czech markets - including tunneling, and insider trading.[107]

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[104] See, "Slovak Meeting Studies Economic Problems," *FBIS*, August 17, 1990; Author's Interview with Milan Sutovec, March 24, 1997.

[105] Butorova et al., *Aktualne Problemy*. Krause, "Different but not that Different".

[106] Many similarly sympathized with the Klaus/Hayek rejection of the "third way" and state-guided industrial projects, as an "intellectual disease." Not surprisingly, they also tended to oppose the new Meciar regime and its commitment to a "social market economy." Interviews with Josef Kucerak, former Chair, Public Against Violence, Bratislava Slovakia, January 13, 1997; Jan Oravec, President, F.A. Hayek Foundation, Bratislava Slovakia, January 30, 1997; Gabriel Palacka, Parliamentary Deputy (KDH), Bratislava, Slovakia, April 18, 1997; Viliam Vaskovic, Parliamentary Deputy (DU), Bratislava Slovakia, February 7, 1997; Rudolf Lachkovic, President, Association of Investment Managers and Investment Funds of the Slovak Republic, Bratislava, Slovakia, June 16, 1997.

[107] Early political tension between IPF's and the government is discussed in OECD, *The Czech and Slovak Republics, 1994*, 12, 158, fn 138.

The industrial managers' employers union - renamed the Association of Employers Unions (AEU) - lobbied the government heavily against the voucher method in the ensuing "second wave" of privatization to be launched some time in 1994.[108] Under Meciar, the AEU succeeded in reshaping the process to maximize the influence of its members in privatization.[109] Yet dismantling the inherited framework was a slow process and generated resistance from funds and Meciar's political opposition. In 1992-3, Meciar's Minister of Privatization, Lubomir Dolgos shifted from a quick and rapid privatization scheme relying on vouchers, to a gradualist transition concept based more on "standard methods" (namely, direct sales, public tenders). The voucher concept remained in place, but only as a "residual or supplementary" method.[110]

Dolgos also sought to incorporate a sectoral industrial policy into his privatization concept. He called on industrial branches (which implicitly meant the AEU's member unions) to develop coordinated privatization and restructuring concepts and suggested that the proceeds from "sales of parts of strategic industries" could finance restructuring of the rest of the sector. He added that "Each sector would elaborate an integral and substantiated view on its own post-privatization functioning." This would involve "prior negotiations of the concept" with each respective ministry.[111]

[108] The AEU was a peak organization, given quasi-privileged status through the tri-partite mechanism set up by the reform socialists of the 1968 era following the 1989 revolution. It was organized according to communist era "branches" such that one of the AEU's unions would represent engineering enterprises, another chemicals and so on.
[109] The AEU's official stance on privatization has been to support "the appropriate method for each firm" and "transparency in privatization decision making." An AEU official refused to comment, however, on the FNM's heavy reliance on one method - direct sales to predetermined owners - and its intransparency under since 1994. More on this below. Interview with Viliam Garay, Director of Economy and Employers' Policy, Federation of Employers' Unions and Associations, February 20, 1997.
[110] Indeed, efforts to determine voucher privatization deadlines or the volume of assets to be voucher privatized in advance, "would. . . fail to serve a purpose." In addition, Dolgos's reformulated concept warned managers that privatization plans that relied too heavily on the voucher method would be "subjected to particularly critical and thorough evaluation." There would also be a critical "assessment of the risks derived from concentration of ownership through privatization investment funds." Instead, Dolgos emphasized "combined methods" in which a management buyout would play an "exceedingly important role". Lubomir Dolgos, Minister of Administration and Privatization of National Assets of the Slovak Republic, "Concept of the Continuing Process of Privatization in the Slovak Republic", (no date); Interview with Lubomir Dolgos, former Minister of Privatization, Bratislava, Slovakia, March 20, 1997.
[111] Dolgos, "Concept of the Continuing Process".

Speed, which dominated the privatization concept in the former Czechoslovakia, was now replaced in independent Slovakia by a more gradual approach and the goal of "a well-functioning social-market economy." Under Dolgos and Meciar, earlier efforts by Klaus and Triska to *break* old socialist-era decision making structures had been abandoned in favor of a concept that *reincorporated* these "old structures" into the privatization process.

Despite the radical shift in privatization emphasis (or rather, perhaps because of it), Dolgos managed to privatize little additional property during his year long tenure. He resigned in the fall of 1993 having completed only several privatization projects.[112] Meciar attempted to appoint Ivan Lexa to replace Dolgos as Minister of Privatization. Lexa was a loyal associate of Meciar, and more amenable than Dolgos to the Prime Ministers whim. He was also solidly connected to the old *nomenklatura* through his father, Vladimir, who had been head of the State Central Planning office and, perhaps for this reason, was thought to be more representative industrial interests than Dolgos. Moreover, while there are rumors about corruption associated with every privatization ministry, Lexa was unambiguously ready to enter into the murky realm of patronage politics.[113]

In the first of a series of bitter and polarizing conflicts with Meciar, President Milan Kovac refused to approve Lexa due to his apparent inexperience and the potential for a conflict of interest with his father who now headed Harvard Capital - one of Slovakia's largest investment privatization companies. This led to an institutional conflict between the office of the Presidency and the government as Meciar mobilized his resources to undermine the President's effectiveness and credibility.[114]

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[112] Much of the problem stemmed from his independence from Meciar. He had, for example, defeated Meciar protege Sergei Kozlik in party elections of the post of HZDS Vice Chair Responsible for the Economy. Perhaps as important, although Dolgos was intellectually committed to an industrial policy-based concept of privatization, he was not from industry and retained a number of independent stands: including a distrust of direct sales due to their lack of transparency; a sincere desire to break up and limit monopolistic control over markets, and the use of competitive criteria when possible to make decisions. Dolgos resigned amid great conflict with Meciar over foreign buyers of Slovak firms, his slow progress in privatization, and other issues. Interview with Lubomir Dolgos, March.20, 1998.

[113] Confidential interview, 1998.

[114] It also looks reasonably plausible that this created what Krause calls, an atmosphere of hostility towards Kovac and the institution of the Presidency that contributed to the beating and kidnapping of his son and the subsequent murder of a witness, Robert Remias, a potential witness who was purportedly able and willing to the kidnapping to the secret service. Kevin Krause, "Slovakia's Democratic Decline".

Beyond attacking the presidency, Meciar skirted the Constitution by placing Lexa in unofficial control of the Ministry and taking on the titular head of Minister of Privatization for himself. In winter 1993-94, Meciar and Lexa privatized several profitable companies to political allies and also used the Fund for National Property (FNM) to appoint political and industrial allies to the boards of Slovakia's leading firms. The apparent management of the process to benefit close allies was highly controversial and contributed to political maneuvering and a devastatingly critical speech from the President that brought down the Meciar cabinet in March 1994.

Meciar's second government was thus replaced by a five-party interim government led by Jozef Moravcik, later of the Democratic Union (DU). Minister of Privatization, Milan Janincina (DU), sought to reintroduce voucher privatization. The goal was quickly and thoroughly to privatize the rest of the economy in a way that would allow the new actors created by the first wave of privatization to consolidate their control over the economy through bank-owned and other IPFs. Some of these financial sector managers were a source of political support for the coalition's center-right members.[115] As importantly, a rapid second wave would break the power of the industrial lobby, undercut a source of financial support for Meciar's HZDS, and allow a center-right government to replace sectoral policy with a broader liberal industrial policy of the type envisioned by Klaus and the Morvacik government's liberals.

Janincina pressed ahead to lock the country into the voucher privatization scheme. In cooperation with the Ministry of Finance, the government issued 3.42 million booklets for the second wave of privatization. This was a 30% higher rate of participation than in the first wave.[116] Once again, a majority of voucher holders placed their investment points with the investment privatization funds.

Industrial interests did not disappear during this period. Rather, they had a strong voice in Peter Magvasi of the formerly communist, Party of the Social Democratic Left (SDL), who had been appointed Minister of the Economy in the broad five party cabinet that followed Meciar's March 1994 dismissal. For industry, forestalling or limiting the influence of voucher privatization was an essential first step to gaining control of their firms. Magvasi, a former industrialist from engineering/defense sector and a leading official in the AEU,

[115]Indeed, despite the ties of large funds like Harvard capital to the Meciar regime, overall there appears to have been somewhat of a "revolving door" between first wave equity market entities such as IPF's and interest representation groups and ministry and government officials from the Carnogursky and Moravcik governments.
[116] Dedek et al., *The Break-up of Czechoslovakia*, 201.

strongly sympathized with this goal, while his party, SDL, competed with HZDS to be the leading patron of industry.

Magvasi advocated a continued plan of direct sales to *predetermined* Slovak entrepreneurs and sought to use the state apparatus to help Slovak industry to restructure.[117] Over the summer 1994, Magvasi and Deputy Prime Minister Brigita Schmognerova used their influence in the Moravcik cabinet to succeed in reducing the scope and delaying the launch of voucher privatization until long after the general elections.[118]

While voucher privatization was reduced in scope and delayed, the Moravcik government approved fifty four public tender and direct sale projects that had been processed by the Janincina Ministry. Most of these were approved after the beginning of the election campaign and a number were approved after Meciar's party had won the election in September 1994 but before he chose to form a cabinet in December 1994.[119]

Meciar's reelection led to another - and this time decisive - shift in privatization policy and gave the Slovak economy a distinct political and economic bias in favor of Meciar's political and industrial allies. In a marathon parliamentary session on November 3-4th, 1994, HZDS took control of the privatization process. Meciar's new parliamentary majority cancelled the Janincina ministry's fall privatization decisions, and indefinitely delayed the start date of the second round of voucher privatization. More importantly, HZDS removed responsibility for privatization decisions from the Ministry of Privatization and vested it in the relatively less transparent Fund for National Property (FNM). Parliament then insulated the FNM from public scrutiny by removing opposition politicians from the oversight and control body (which also looked over the public media and secret service!) and appointed only party or coalition partner loyalists to its supervisory and managerial boards. The Constitutional Court later ruled that as a joint stock company, the FNM did not require government review or regulatory oversight. Hence, these boards were particularly important.[120] Meciar claimed that insulating the privatization

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[117] Janincina claims that SDL provided him with a list of entrepreneurs preselected to receive companies. Interview with Milan Janincina, Bratislava, Slovakia, March 10, 1997.

[118] They also contributed to the resistance of a plan by Janincina and his subordinate Gabriel Palacka, to bring foreign capital, competition and a decrease in Russian dependence to the energy sector. Interview with Gabriel Palacka, April 18, 1997; Interview with Milan Janincina, former Minister of Privatization, Bratislava, Slovakia, March 10, 1997

[119] Miklos, "Economic Transition".

[120] In fall 1997, Parliament finally gave into EU and opposition pressure and appointed Ivan Miklos to the supervisory board of the FNM. Sadly, this was somewhat akin to inviting in the policy to protect an already looted home.

process from opposition would allow the FNM to make decisions according to technocratic criteria, free from political influence. It also allowed him to claim in 1998, when the damage was done, that although he still agreed with his "concept" of privatization, he had not been responsible for its administration.[121]

Privatization as a Political Strategy[122]

The long and complex list of developments in the actual conduct of Slovak privatization under Meciar's last regime has been extensively covered elsewhere.[123] In theory, Meciar's privatization "concept" has been similar to the Dolgos era. This included working closely with industry allowing it to achieve ownership patterns that would be most appropriate to a sectoral industrial policy of its own design; reserving the voucher method to be used only as a supplementary or residual method; and providing preference to domestic managers over foreign investors.

There were key differences with the Dolgos approach, however. Whereas Dolgos had distrusted direct sales because they could be easily corrupted, Meciar's FNM used them in an overwhelming number of cases. Also, where Dolgos had sought strategic foreign partners for some Slovak companies, Meciar FNM's unofficially shut out foreign inquiries. In the few cases where shares were "auctioned" on the equity market, the FNM announced the time of the sale only to the intended buyer. Intransparency allowed Meciar's privatizers to manipulate the privatization process to the benefit of industrialists and party insiders. But where privatizers did not fall into one of these two tight circles, second hand anecdotes indicate that a well-placed bribe may have been an influential criterion.[124]

The primary result has been a system of patronage in which the benefits

[121] CTK News, May 8, 1998.

[122] Due to the politicization of the economy in Slovakia, I have decided to leave a number of interviews in this section confidential. The reference "Confidential interviews" here information gathered in one or more of: a) four interviews with individuals with audit experience at big six accounting firms; b) four interviews with capital markets actors and c) two officials from the foreign financial assistance community and three bankers. Most of these interviews were conducted in spring 1997. Where information is second hand it is indicated

[123] Ivan Miklos, "Privatizacia" in Martin Butora & Michal Ivantysin (eds) (1998) *Slovensko, 1997: Suhrnna sprava o stave spolocnosti a trendoch na rok 1998*, Bratislava, Institut pre Verejne Otazky 418-20; Ivan Miklos, "Corruption Risks in the Privatization Process" Mesa 10, Bratislava, Slovakia, 1995; "Economic Transition"; Antonin Marcincin, "Slovakia: The Family Circles Privatization", Bratislava, Center for Economic Research, 1996.

[124] Confidential Interviews.

flow to the politically connected. From 1995 through the end of 1996, the main privatization decisions were carried out under the supervision of two HZDS officials, FNM Chairman Milan Rehak and FNM Co-Chair and Director of the Direct Sales Section, Jan Porvaznik. As titular head of the FNM, Parliament chose Stepan Gavornik of the ZRS. They guided a swift series of direct sales to Slovak entrepreneurs. Essentially immune from scrutiny, the FNM publicly disclosed little information about the stipulations or criteria behind the sales, but the shares were generally sold on generous terms - below book value and below market price, with the result that the FNM now has to borrow money to meet its obligations. In a typical management buy out, the buyers would receive the company for as much as one third, one-fifth or less of its book value. They would then borrow bank money to make a minimum down payment of 20% of less. Moreover, money used to meet FNM installments (spread over as much as ten years) could be deducted from the company's tax bill. On a number of occasions, such as the sale of the highly profitable oil extraction company, Nafta Gbely, the new physical owners of the company remained a matter of intense speculation among opposition politicians and the press.[125]

Officially, the Meciar government employed popular economic nationalist and xenophobic rhetoric to justify their choice of privatization program. It boasted of protecting Slovak firms from speculative foreign capital and privatizing only to "domestic business subjects" in order to create a "class of national entrepreneurs" with a "national consciousness." National entrepreneurs would then deal with their assets as they saw fit in what Meciar predicted would be a "third wave" of privatization. Foreigners, Meciar stated, would come in at later stage as strategic partners for Slovak entrepreneurs.[126] Yet, in practice, Slovak government officials remained deeply suspicious of foreign direct investment and often sought to block foreign partnerships. "We just want to avoid them coming in and closing [the company]," remarked one FNM official, "Investors only come to misuse companies and disappear."[127]

In one example, notable for its senselessness, a foreign advisor to the government relates that he worked with an entrepreneur to acquire a strategic partner to modernize and expand production of his product line for export abroad. While the entrepreneur was not explicitly prohibited, he received

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[125] Marcinsin, "The Family Circles;" Miklos, "Corruption Risks"; "Economic Transition".
[126] An additional element of economic nationalism was embodied in the Strategic Company Act. This bill was written by the Ministry of Economy and passed by Parliament in July 1995. For a more in depth description see Marcinsin (1996) "The Strategic Companies Act", Bratislava, Center For Economic Research; Miklos, "Economic Transition", 65.
[127] Interview with Oto Bologh, Press Spokesman, Fund for National Property, Bratislava, Slovakia, April 22, 1998.

several phone calls from top officials in one ministry warning him that he would be held fully accountable if even one Slovak lost his job as a result of the investment. He lost his nerve and cancelled the deal. The enterprise thus remained in debt and was unable to raise the money on its own for modernization; nor was it able to make marketing contacts abroad. The advisor noted that this was typical of the government's attitude towards foreign joint ventures.[128]

Privatization's Partial Reforms

As in the Czech Republic, Meciar's privatization program produced partial reform rents. That this would be the case was not necessarily pre-ordained. One of the advantages of management buy-outs was supposed to be the creation of clear owners who would seek the highest rate of return on their assets by restructuring. But in reality, the new owners were never exposed fully to the downside of lax financial discipline. While credits and subsidies were not exactly readily supplied to most poorly performing firms, neither were firms threatened with liquidation. Eventually, (and due in part to missed tax payments or the need to subsidize a banking sector beset with non-performing enterprise loans) a slow drain on government resources led to growing deficits, government borrowing, crowding out of private investment, and even poorer corporate performance.[129] Many of the origins of this downward spiral can be found in the network of industry-state-party (HZDS) ties generated in the privatization process.

a. Industry's Influence in Government Policy: Slovakia's doubly focused privatization framework strengthened a state-society network that gave disproportionate policy influence to Slovakia's industry and created the basis for political and economic rent seeking. Second hand anecdotes suggest that much of HZDS party finance came from privatization-related kickbacks from industrial beneficiaries.[130] More evident however is the fact that the key

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[128] Most of the foreign financial services executives and consultants I spoke with have similar stories. Confidential interviews.

[129] Between 1996 and 1998, the government pumped $US 1.343 billion to "either directly of indirectly rehabilitate commercial banks." This total was approximately the equivalent of 7.0 % of 1997 GDP.

[130] One opposition campaign manager recalls being shocked at how HZDS managed to buy billboard ads and space at market rental would have outstripped the legal limit of campaign spending in the 1998 election. One way HZDS might have finessed this is by calling in favors from former privatization clients to provide goods and services at a fraction of their real cost. In one example, movie stars were flown to Slovakia to campaign for HZDS in a corporate jet owned by the country's largest company, VSZ Holdings, a.s.. VSZ President, Alexander

criterion for receiving benefits in privatization, or dispensations from economic burdens, was a close connection to the government or the AEU-dominated, industry-government network. HZDS members were generally pretty open about this. As the late former Minister of Industry Jan Ducky argued, "every government gives advantages to those groups that cooperate with them. This is not controversial." In their defense, HZDS officials argued that economic policy would be equally clientalist if opposition parties controlled it.[131]

AEU officials lobbied hard for a cancellation of the second round of voucher privatization. To many managers, canceling voucher privatization was a matter of survival. After the first wave, investment privatization companies had taken a large stake in a number of firms and now competed for control of these firms with industrial managers. A second round of voucher privatization would have decisively shifted control to the funds.

In early summer 1995, the government cancelled voucher privatization entirely. AEU President Michael Lach claimed partial credit for the decision, explaining, "the privatization philosophy assumed by the government has been formulated jointly."[132] The cancellation of voucher privatization made it even easier for managers to acquire their companies cheaply. The government compensated voucher holders with an FNM bond worth a face value of 10,000 SKS plus the National Bank of Slovakia's discount rate. Ensuing government policy allowed bonds to be traded and a market developed in which the actual trading value was 75% or less of the face value. Industrial managers could, meanwhile, purchase these bonds below their face value and then use them to pay off their privatization debt to the FNM at face value.[133]

AEU influence could also be detected in government regulation of equity markets. Unlike Klaus' Ministry of Finance, Meciar's Finance officials had few

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Rezes, was HZDS campaign manager. Discussion with Tibor Papp, Campaign Director, Party of the Democratic Left, July 1998.

[131] Author's notes from "*Slovak Spectator* Live, Debates for Democracy Series: Brigita Schmognerova & Jan Ducky," Bratislava, (DATE), 1996. Interview with Oto Balogh, April 22, 1997.

[132] *Slovenska Republika*, June 21, 1995, as cited in Miklos, "Economic transition", 65; See also, Association of Employers' Unions", 5. Vyrocie AZZZ SR, 1991-1996," *Spravodaj AZZZ Extra*, Bratislava, March 1996.

[133] Bonds could be redeemed with interest after five years. Bond holders could also redeem them to bid for shares in some limited number of enterprises or purchase health and pension insurance. According to the world bank, while a minimum price of 7,500 SKS is in place, often bondholders have sold out for much less. The effect has been to allow entrepreneurs to lessen the price they pay for their enterprise at the expense of the defunct voucher program. World Bank, *A Strategy for Growth and European Integration*, 31-2.

compunctions about aggressively regulating the market. Slovak regulators claimed to target the same abuses by fund managers and market speculators that plagued Czech markets and blamed these abuses on the voucher privatization concept. A July 1995 amendment to the Collective Investment Act went much further than Czech regulations to improve transparency and protect minority shareholders.[134] The law was nevertheless easily circumvented, however, leaving minority shareholders under protected.

But while the Meciar government did take some, albeit inadequate, steps to regulate the markets, it also targeted the ownership rights of investment privatization funds. Some speculate that this done was on behalf of the AEU's managers which saw in them a rival for control of their firms.[135] In September 1995 Parliament circumscribed the power of IPF's to act as owners. It reduced the maximum proportion of shares that IPFs could hold in other corporate entities from 20% to 10%, and forbade them to appoint representatives to directorial boards.[136] Many IPFs circumvented the regulation by converting themselves into holding companies - a controversial move that was upheld by the courts - much to the frustration of the Ministry of Finance regulator, Jozef Magula, who argued it was specifically prohibited by the law.

In September 1996, Parliament passed a law that completely eliminated all regulation on trades and made the market virtually opaque. The President vetoed the legislation and Ministry of Finance regulator, Magula, spoke in front of Parliament explaining the negative ramifications of the bill for the average small shareholder and upon the ability of Slovak firms to raise capital in the future. Parliament responded with a second, but still inadequate bill in early 1997 that restored some transparency and shareholder protection but still allowed enterprises to trade anonymously off the market at unknown prices - often at a detriment to minority shareholders.[137]

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[134] There was at least some minimal attempt to protect minority shareholders, including the requirement to publish all trades that brought ownership up or down 5%, with some stipulations to buy out minority shareholders at the market price if ownership exceeded 30%.

[135] Rudolf Lachovic, "Vzt'ah kuponovej metody privatizacie a kolectivneho investovania," Global Brokers, Bratislava, 1997, manuscript.

[136] Known as the Investment Corporations and Funds Act, Miklos, "Economic Transition", 66.

[137] Interview with Jozef Magula, National Bank of Slovakia, Bratislava, Slovakia, July 28, 1998; Interview with Rudolf Lachovic, Chief of the Board of Directors, Global Brokers, Bratislava, Slovakia, June 23, 1997; For early market regulatory climate, see Andej Juris (ed.) (1994) "Capital Market Development in Slovakia", Seminar Bulletin II, Center for Economic Development, Bratislava.

The result was a still woefully intransparent market. As in the Czech Republic, minority investors ventured their capital at their own risk and were frequently rewarded by having the value of their shares slowly evaporate or disappear virtually over night. For similar reasons foreign portfolio investment fled the market for all but a few "blue-chip" stocks, while domestic investment either fled abroad or into the money or state securities market.[138]

Despite Magula's timely intervention in Parliament on behalf of minority shareholders and transparency, between 1995 and 1997, he gained a reputation among Meciar's opponents for politicized and potentially illegal regulatory decisions. In early 1995, the Ministry of Finance took aggressive actions against the largest, most successful privatization fund company, Prva slovenska investicna spolecnost (PSIS). Magula claimed PSIS had violated a number of legal stipulations in order to attract voucher booklets for the second wave of voucher privatization and suspended their license. The Constitutional Court overturned the decision but the Ministry of Finance revoked the license a second time in 1996. According to one account, it then put enormous pressure on Vladimir Lexa's Harvard Capital before the senior Lexa agreed to manage PSIS's highly successful Sporofund.[139]

Magula claims that the courts were politicized and refused to uphold the letter of the law.[140] He was supported in the claim by Meciar's economic advisor and Magula's subsequent replacement, Peter Stanek, who likened the Ministry's conflict with the courts to "trench warfare."[141] For both officials, the apparent politicization of the court's decision justified Magula's decision to ignore its rulings.

But opposition analysts argued that it was the Ministry's attack on PSIS that was politicized. PSIS, through its largest fund, Sporofund, was also an important shareholder of *SME*, a leading daily newspaper with a significant pro-opposition slant. PSIS management was also rumored to have strongly supported the Democratic Union, an opposition party containing a number of former Meciar colleagues from HZDS, in the 1994 general election. But perhaps most importantly, as Slovakia's largest investment privatization company, PSIS became a rival to industrial management on the boards of a wide number of Slovak companies in the first wave of privatization. Had it

138 Economist Intelligence Unit, *Slovakia Country Report*, 1997-8, 30.
139 Confidential interview with former Slovak broker, Prague, Czech Republic, July 25, 1997.
140 Interview with Jozef Magula, National Bank of Slovakia, Bratislava, Slovakia, July 28, 1998.
141 Ibid.; Interview with Peter Stanek, Economic Advisor to the Prime Minister, Slovak Government Offices, Bratislava, Slovakia, January 16, 1997.

successfully competed in a second wave of voucher privatization, the balance of power on many boards would have tipped decisively in favor of PSIS and other investment funds.

Indeed, the conflict between the courts and the Ministry of Finance over PSIS can probably be boiled down to this simple, zero-sum fight over which actors would control large numbers of companies: the pro-Meciar managers of the AEU or the pro-opposition managers of some (but not all) of the principal investment privatization funds. This conflict was sharp, and liberal democratic institutions - the balance between autonomous centers of government authority and universal application of the rule of law - were the primary victims.

b. Manipulation of Debt: Coupled together, the Czech and Slovak experiences confirm the Coasian observation that a government's capacity to enable and enforce contracts is more important to the efficiency of privatization outcomes than the first distribution of property rights.[142] Indeed, while the Meciar government's privatization policy led to more rapid concentration ownership than Czech privatization, it did not produce more efficient behavior on the part of the new owners or their creditors. According to a series of confidential interviews with Western financial services experts and equity market actors, Slovak owners often engaged in the same sub-optimal behavior as their Czech counterparts - even though they frequently had greater control over their firms.

Much of the reason relates to debt. Like Czech firms, Slovak firms carry a large outstanding burden of debt which they were not necessarily pressured to honor. Three reasons existed for this. First, similar to the Czech lands, Slovakia's bankruptcy law privileged debtors over creditors producing an enormous problem with moral hazard. Second, and also similar to the Czech lands, the administration of the first wave of voucher privatization in Slovakia led to an initial concentration of privatized property in bank owned funds. These state-owned banks suffered many of the same conflicts of interest as their Czech counterparts. They thus frequently failed to discipline client firms - particularly if it would entail significant unemployment or harming the interests of a politically connected manager.

Third, privatization by management buyout - like voucher privatization - failed to bring new cash or debt relief to the companies. Despite the often symbolic purchase prices and favorable repayment terms, managers would often increase debt by borrowing to make their down payment to the FNM.

[142] Coase, "The Problem of Social Cost".

They then sought to pay off this debt as well as meet the installment obligations of their outstanding FNM debt though the earnings of the company.

This did not bode well for restructuring. Managers privatized their firms only to find themselves apparently condemned to eke out a living at the margins of solvency for years on end.[143] Facing such choices, and given lucrative opportunities for cash assets elsewhere, new owners would occasionally strip their companies and return them to the FNM before making the first installment payment. Other managers would slowly consume the company - meeting its minimal obligations to the FNM and tax office, defaulting on inter enterprise debt and siphoning off the extra cash.[144] Officially, the FNM was allowed to control major asset transfers in firms with an FNM debt, but in practice they were too over-stretched to monitor all transactions and some FNM monitors may have even profited from them.[145]

In addition to the FNM debt, most firms that privatized under the FNM-sales regime of 1995-1997, owed money to one of three state-owned banks, and were sometimes behind in tax payments to the Ministry of Finance. This thus gave the government a number of direct channels by which it could provide favors or punish uncooperative behavior. Ironically, it also meant that the incentives to rip-off stake holder and minority shareholders were greater for owners who did not enjoy close contacts to the government. Unlike their well-connected competitors, they were not likely to win any dispensations from government creditors at the state-owned banks, the FNM or the tax office. In some cases, however government officials were more concerned with earning bribes than granting dispensations based on political behavior.[146]

In short, Meciar's HZDS - through the government - held the ends of the long strings of debt that permeated the economy. Ideally, given its commitment to sectoral industrial policy, these debt obligations should have been used by the government and Ministry of the Economy to coordinate restructuring efforts. Indeed, the Ministry of the Economy's official statement on industrial policy made it clear that control over liability networks was a crucial component of its effort to engage in industrial restructuring. The Ministry of

[143] Confidential Interviews.

[144] Indeed, one EU sponsored consultant that I spoke with actually advised his clients to engage in a similar "triage" strategy of debt management. Specifically, he advised that managers should simply default on obligations to those creditors who were no longer essential to the firm while meeting obligations to those creditors who were. Confidential interviews.

[145] Interview with Oto Balogh, April 22, 1997; Confidential Interviews.

[146] Confidential interviews.

the Economy also sought to promote the development of asset networks, "by supporting groupings of enterprises into holdings," to "pool investment resources."[147]

Yet the reality was that due to HZDS permeation by industrial interests, it was the AEU (as well as those firms that could "arrange" for ad hoc dispensations) that often pulled the strings of Slovak industrial and privatization policy. The result was that state-society networks were used to channel present and future tax revenues into the pockets of politically important industries and individuals.

c. Revitalization and industrial policy: Even inter-enterprise debt provided opportunities for government manipulation. Generally, the government inherited and retained a bankruptcy framework that privileged debtors over creditors. As most AEU members were debtors, there was little incentive for a change in policy. Yet the government also passed a controversial Revitalization Act that granted chosen firms the right to enter into a state sponsored debt relief program.[148] The Revitalization Act was designed in conjunction with the Ministry of the Economy on behalf of Slovakia's hard hit engineering and machinery sectors. Based largely on tax relief, in practice it was used to "restructure" companies owned by the quasi-private holding company, DMD Holdings a.s. DMD (run by Meciar's former Minister of Finance Julius Toth) is an umbrella holding company for a network of former state-run defense manufacturing firms that were most severely hit by defense cutbacks at the end of the Cold War.

In addition to restructuring, DMD also profited from significant Ministry of Economy support - mostly in the form of encouragement and coordination - for the development of a an indigenous automobile supply network.[149] Industrial elites - particularly in the construction industry - profited enormously from a massive infrastructure development program that required significant government borrowing.

d. Politicization of Bank Privatization: The doubly focused privatization framework raised levels of conflict surrounding bank

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[147] Ministry of the Economy (1997) "Slovakia's Industrial Policy Update", ministry document.
[148] *Ibid.*, 18.
[149] AEU "5. Vyrocie AZZZ SR"; See also the interview with Ministry of Economy Plenipotentiary for the Automotive Industry in Slovakia, Alfred Richter in Samuel Bibza, "Velky Plany", *MOT,* August 1998, 4-8. Interview with Jan Lesinsky, President, Slovak Society of Automotive Engineers, Bratislava, Slovakia, August 10, 1998.

privatization. Like the Czech Republic, the Meciar government tried unsuccessfully to privatize its four largest financial institutions. Yet Meciar's politicization of privatization led his political opposition to form a one-time coalition with HZDS governing partner ZRS to get the banks placed on a list of strategic enterprises. The opposition hope was to prevent the privatization of the banks to the AEU's industrial debtors.

A few key ZRS deputies later reversed their vote allowing the privatization of two banks, Vseobecna uverova banka (VUB) and Investicna rozvojova banka (IRB).[150] Even without the reversal however, Slovakia's largest company, VSZ Holdings a.s. (which is in turn the majority owner of Slovakia's largest steelworks) ignored NBS regulations and rulings to gain 40% control of the highly undercapitalized IRB through its network of over 147 daughter companies and associated holdings.[151] Significantly, the bank's other major shareholder, the FNM, voted with VSZ "as a block" at IRB's general shareholders meetings.

VSZ then treated the bank like one of its daughter companies. Rather than seeking a foreign partner to help recapitalize and begin to rationalize its high proportion of classified loans, VSZ's new management team allowed the situation to deteriorate - contributing what the NBS has since "suggested" consisted of "serious illegal transgressions which negatively influenced the bank's activities" IRB failed to meet its depositors demands when they lost confidence in the bank. This forced IRB to submit to National Bank administration in December 1997. In spring 1998, VSZ then used its influence with the FNM and shareholdings in the two remaining state financial institutions, Slovak poistovna (state insurance company) and Slovenska sporitelna, to provide a costly capital injection, while it refused to contribute any cash of its own beyond the initial amount required by the NBS. Nor was there any real attempt by VSZ to find an adequate foreign buyer.[152] VSZ's treatment of IRB perhaps justified the decision by the opposition to block the privatization of the remaining two financial institutions until foreign partners could be found.

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[150] If we include the third state owned financial institution, Slovenska sporitelna, these three banks account for as much as 90% of all Slovak deposits and 60% of all loans. Economist Intelligence Unit, *Slovak Country Report, 1997-8*, 29; *Slovak 1st Quarter Country Report, 1988*, 17.

[151] According to Ivan Miklos, VSZ President Jan Smerek, accused the NBS of "disliking VSZ and, apparently, disliking Slovakia's development." Miklos, "Economic Transition," 71-2.

[152] Peter Laca (1998) "Troubled IRB bank approves capital injection", *The Slovak Spectator*, May 7-21. An added wrinkle was that the collapse was triggered by an illegal transfer of budgetary funds earmarked to compensate IRB for low-interest loans to subsidize young couples and home builders. This money was appropriated by Ministries controlled by the Slovak National Party (SNS). Confidential interview, 1998.

e. Slow Restructuring: By the end of Meciar's third term, his government's politicized and clientalized privatization and industrial policies had virtually stalled enterprise restructuring in Slovakia. Firms that sought an injection of capital to restructure had to face, among other things: poorly functioning equity markets rendering an initial public offering nearly impossible; a government that was suspicious and even hostile to foreign strategic investors; politicized or rent-seeking government decision making that frequently violated the equal application of the rule of law; and an increasingly profligate fiscal policy, capped by a costly infrastructure development program that crowded out borrowing.

By Spring 1998, the Meciar government had to finance this by borrowing on European markets at 3.5 percent above LIBOR. It also borrowed short term domestically at a nominal rate of 28 percent. The high level of domestic borrowing aggravated the credit squeeze on Slovakia's already strapped enterprises.[153] Against this background of short term borrowing to meet long term debt obligations, the Slovak macroeconomic "miracle" under Meciar now appears to have been largely financed, over the past two years at least, by unsustainable fiscal spending and borrowing.

f. Institutional decay: As noted, privatization and related implementation of industrial policy also had institutional effects. The politicization and clientalization of the Slovak economy was characterized by a disregard for (and subjective implementation of) the rule of law, unconstitutional legislation and a willingness to disregard the rulings of the Constitutional Court; and the politicization of government procurement, import and export policies, tax enforcement, debt restructuring measures, the extension of credits from state-owned banks, as well as the issuing of licenses to equity market actors.

This was based on a government policy that (until fall 1997) excluded any significant opposition oversight of, or participation in, privatization, and sought to undermine any independent centers of authority that challenged its control of the process. Most notably, these attacks included the Presidency, investment privatization funds, the state-run media (an independent, opposition-oriented private media flourished, however), and the National Bank of Slovakia (NBS).

[153] One benefit may be that the profits from state borrowing are recapitalizing the Slovak banking sector. M.E.S.A 10, *Slovak Monthly Report*, May 1998, 1-2; M.E.S.A 10, *Slovak Monthly Report*, July 1998, 2.

This latter infringement is significant because the tight monetary policy of the NBS was a crucial element in the strong macroeconomic performance of Slovakia. Yet since NBS monetary discipline also significantly raised the cost of credit, maintained the real value of liabilities, and put constraints on fiscal policy, the NBS came under pressure from the Ministry of Finance to be more cooperative with Slovak industrial policy. In 1997-8, the NBS narrowly escaped an attempt by Parliament to place it more directly under Government control.[154] Heavy borrowing, low foreign investment and this attack on the NBS led major investment rating agencies to downgrade Slovak bonds to below investment grade level in Spring 1998.[155]

Slovakia's democratic decline also had an international institutional price. In 1996 and 1997, NATO and the European Union both decided against inviting Slovakia to join advanced postcommunist states to enter accession negotiations. Notably, the European Commission remarked in its critique that the chief reason for Slovakia's exclusion was the low "stability of institutions and their integration into political life."[156]

Dislodging the Winners

Prior to the 1998 elections, the key to dislodging Slovakia's rent seekers lay in challenging their political patron, HZDS. This potentially was a mixed blessing. On the one hand, all it would take was one successful election and the beneficiaries of Meciar's economic patronage would be forced to approach the new "party of power" on highly disadvantageous terms. The apparent strategy was thus simple and straight forward: cut off the head and the body would whither.

On the other hand, this approach was extraordinarily dangerous. The divide between winners and losers closely traced the country's political divide. Due to the full participation of the state in delivering partial rents, moreover, dislodging the winners would eventually require dismantling a state apparatus that had been mobilized on the behalf of Slovakia's industrialists. Indeed, it appeared that the fundamental interests of Meciar's closest industrial allies were at stake in the 1998 election. As if to emphasize the point, Meciar's opposition made a number of promises during the campaign to reopen the books on

[154] Economist Intelligence Unit, *Slovak Country Report, 1st Quarter 1998*, 16-7.
[155] "Another Agency Downgrades Slovakia's Risk Indicator", *The Slovak Spectator*, May 7-21, 1998, 5.
[156] European Commission, *Commission Opinion on Slovakia's Application*, Sec. 1.3.

privatization and prosecute those that broke the law.[157]

Challenging the winners in the 1998 election thus raised the level of political conflict to a point where it potentially threatened Slovak electoral institutions. In the run-up to the election, HZDS amended its electoral law in ways that gave the Ministry of the Interior greater influence in counting the vote, put ambiguous and potentially expandable limits on the ability of the private media to cover the election, and shackled the ability of small parties or coalitions to compete in the election. In August 1998, HZDS had the courts review its prime opponent's eligibility to take part in the elections.[158] Following the election, it held on to power until the very last possible minute in order to arrange for the interests of its members and allies. Throughout this period, there was there was increasing speculation that would Meciar prefer to violate democratic principles than to give up power.

On hindsight, however, HZDS's aggressive polarization and clientalization of the country may have done its opposition a favor. Motivated by a sense of crisis, a non-governmental organization, OK'98, mobilized youth to vote with the clear understanding that they would vote against Meciar in overwhelming numbers. A remarkable 84.2% of eligible voters turned out. HZDS emerged from the election virtually isolated on the political scene with a mere .7% plurality over its rival Slovak Democratic Coalition (SDK). Not a single opposition party was willing to negotiate a coalition with HZDS participation. United primarily by their negative experience in the opposition, Meciar's opponents united to form a grand coalition with a constitutional majority in Parliament and SDK at its head.[159]

The new government coalition has shown some willingness to challenge the legacy of Meciar's industrial networks and restore damaged political institutions. Both steps require forgoing substantial short term political advantages that profited the former regime. As of this writing, VSZ Holdings, Slovakia's largest company led by one of Meciar's staunchest allies is near bankruptcy. The government is insisting that VSZ's owners surrender control

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[157] John Gould & Sona Szomolanyi, "Bridging Slovakia's Elite Chasm", *Transitions*, November 1997.

[158] J.M. Viersma, "Správa docasnej pozorovatelskej misie na Slovensku," *Euro Report*, no.15, 1998, 22-23.

See also John Gould & Sona Szomolanyi (1999) "Elite Division and Convergence in Slovakia" in John Higley, & G. Lenyel (eds) *Elites after State Socialism*, Boulder, Colorado, Rowman and Littlefield.

[159] Martin Butora & Zora Butorova, "Slovakia's Democratic Awakening", *Journal of Democracy*, January 1999, 80-95.

before the firm be given any kind of state relief. Rather than simply take over the reigns of patronage from Meciar, the new government appears to be intent on dismantling patronage networks.

While reducing the influence of industrial owners over economic policy is a crucial first step to eliminating partial reform rents, as I have argued elsewhere with Kevin Krause, the government also needs to repair damage done to Slovak institutions. This includes restoring the principle of equal application of the rule of law for all economic subjects; enhancing the integrity of independent centers of authority - such as the courts, the presidency and local governments; and then using the government's constitutional majority to lock these changes into place. They could also make change harder by raising the number of deputies needed to make constitutional changes from the low current level of 3/5^{ths} to 2/3^{rds}.[160]

A policy of institutional renewal will reduce rent-seeking and dampen social and political conflict. Reducing industry's unequal access to decision making will make control of the government less important to securing wealth. It also limits the ability of those who control the government to pursue policies that are catastrophic to their opponents. Individual institutions have less power - hence groups will fight less bitterly to win control over them.

There are political impediments to a full strategy of institutional renewal, however. Bitter conflict may lead the new government to feel that it should not strengthen the powers of institutions that HZDS might eventually control. Should Meciar or an ally win upcoming elections for the Presidency, for example, the government might decide not to restore some of the powers of the Presidency removed by Meciar's last government. Indeed, strengthening institutions entails being more generous to HZDS and SNS in the opposition than either of these parties were when they were in power. Yet in the long run, preventing a return to rent seeking and intense social and political polarization requires institutional renewal now. To return to the central metaphor, this policy is essentially one of turning down the thermostat.

[160] Gould & Krause, "When Elections Matter Too Much"; Krause & Gould, "Self-Interested Generosity".

CONCLUSION

The politics of reform have played themselves out differently in the Czech and Slovak Republics. The "loser backlash" expected by Latin Americanists in the early stages of reform never came in the Czech lands,-and in Slovakia, it took an unexpected direction. The communist era left Slovakia and the Czech lands with weak and compromised societal formations that could not defend their interests against reforms imposed by the state. This was bolstered in the Czech Republic by strong, pro-reform preferences and reasonably dynamic job creation resulting from unique economic advantages.

In Slovakia, where preferences tended to be more favorable to the material status quo, economic vulnerabilities brought sharp increases in unemployment. Societal interest groups, particularly industry, recovered more quickly when their complaints about the country's sharp economic downturn corresponded with concurrent nationalist sentiment for greater economic and political autonomy. In 1992 Meciar promised more Slovak control over economic reforms and greater sensitivity to local conditions in their application. Perhaps as importantly, the new popular-nationalist reform concept provided for an enhanced role for old industrial interests in setting industrial and privatization policy.

Similar to the initial reform period, reforms since the Velvet Divorce have closely reflected unique Czech and Slovak paths of development. Choices of privatization frameworks were a "critical juncture" in each of these paths. The Czechs under Klaus, continued with the "doubly diffuse" concept inherited from the former federal republic. This created enormous problems in corporate governance, equity markets and the financial sector and contributed to slower growth, delayed restructuring and higher public debt. The primary beneficiaries of these market distortions were market and financial insiders who had the information they needed to benefit from post-privatization's market distortions. Klaus' ODS similarly benefited, at the very least, by not pushing for faster reforms that would have restructured industry. ODS thus avoided paying the political price of strings of bankruptcies and rising unemployment prior to the 1996 general election.

But the winners from partial reforms were dispersed across party lines and interest groups. Challenges to winners thus put ODS against ODS; bankers against bankers and brokers against brokers. The dispersion and low salience of political divisions had a taming effect on the politics of reform in the Czech Republic. Attempts to dislodge rent seekers were, for the most part, handled through democratic institutional channels. Yet the murky results of the June

1998 election blocked swift movement in this direction. An agreement between ODS and CSSD gave ODS a chokehold over decisive left-leaning reform choices by the new government. As CSSD and ODS continue to disagree over specific reform prescriptions, reform remains slow.

Meciar's "doubly focused" privatization framework, by contrast, produced a highly coherent state-party-industrial alliance - knit together by a economic nationalist rhetoric, concentrated privatization benefits, a clientalized policy of debt manipulation, and self-interest. As in the Czech Republic, privatization produced opportunities for rent seeking by managers, funds, bankers and politicians. Unlike the Czech experience, however, Slovak privatization focused its rewards on a coherent network of political and economic actors. To provide privatization benefits to these actors and not others, Meciar had to undermine the integrity of a number of liberal democratic institutions: including horizontal accountability, rule of law and constitutionality. This diminished Slovakia's chances of joining its neighbors in integrating with the West.

Because privatization in Slovakia fused economic rent seeking to political power, challenges to partial reforms were simultaneously challenges to Meciar's HZDS, the state, and some top industrial leaders. This raised the stake of political competition and led to the political isolation of HZDS. In September 1998 elections, Meciar's opponents won enough seats in Parliament to change the Constitution. They then formed a fully inclusive grand-coalition of former opposition parties. This has provided them with an unparalleled opportunity to dismantle patronage networks and create robust liberal democratic institutions. By ensuring that institutions this time remain the arbiters, rather than the products, of distributive conflict, Slovakia's new government could help to ensure its country's democratic future.

John GOULD
Columbia University/Tufts University
jagou@aol.com

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