

Analysis of the different methods of privatization and restitution in Czechoslovakia

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I. Introduction

1. Historical background

In 1991, the Czechoslovak government carried out a program of simultaneous democratization and mass privatization. In order to get the privatization process started, a stock market was created and the state got rid of large holdings in many companies and numerous other enterprises.

At this time however, the Czechoslovak economy was technically out of date and suffering from a low rate of productivity.¹ Rather than tolerating to a certain extent small, semi-private businesses in the manufacturing and service sectors, the Czechoslovak communists nationalized the majority of the privately held businesses, structuring them as either state enterprises or cooperatives.² In 1989, state-owned enterprises accounted for almost ninety-eight percent of Czechoslovakia's Gross Domestic Product (GDP).³

¹ Mejstřík & Sojka, *Privatization and Regulatory Change: The Case of Czechoslovakia*, PRIVATIZATION AND REGULATORY CHANGE IN EUROPE (1994), page 66.

² Gutiérrez Jr., *Righting Old Wrongs: A Survey of Restitution Schemes for Possible Application to a Democratic Cuba*, p. 411.

³ Sojka, *Czech Transformation Strategy and its Economic Consequences: A Case of an Institutional Failure (or the Economic Consequences of Mr. Klaus.)*, GRANT AGENCY OF THE CZECH REPUBLIC, PROJECT NO. 402/03/1105 'Selected Aspects of the Czech Economy Performance from the Perspective of Accession to the EU', page 117.

Even in the Soviet Union, state-owned enterprises never had that much influence on the GDP.

After the end of communism, the demand of the public was to privatize at once in order to stimulate the economy and thus increase the growth the country needed. However, due to the difficult economic circumstances, transition to market capitalism seemed to be a very remote goal. To reach it in spite of the mentioned circumstances, the first Minister of Finance Klaus proposed to privatize state assets in three major ways: restitution, small-scale privatization and large scale privatization.

2. Preparing for privatization

The Czechoslovak government realized early the importance of maintaining realistic expectations in regards to the privatization process among the citizens. Aware of the fact that "rhetoric and reality must strike a balance"⁴, Czechoslovak leaders warned citizens in advance that privatization would be an arduous process. The Czechoslovak people confirmed this approach by complaining little about the economic hardships during transformation. Thus, the psychological preparation proved successful in order to make Czechoslovak citizens ready for the privatization process.

II. The three ways of privatization

1. Restitution

a) Background and goals of the restitution process

As the first method, the Czechoslovak leaders chose to return property expropriated by the communist regime to its rightful owners in order to

⁴ Greenberg, *Czechs get Reform Balance Right; Tempering Rhetoric with Realism is Proving a Success*, GUARDIAN (London), Feb. 26, 1994, page 33.

make way for a market economy with private property rights.⁵ Real estate represented the largest segment of assets to be restituted. Most of the original owners of landed property were farmers and enterprises as well as religious orders.

In 1990, the Czech and Slovak Federal Republic passed two restitution laws. These laws served to reestablish ownership of assets, such as real estate and companies that were seized in the latest wave of communist expropriations, beginning in 1948.⁶ Apart from the one in the former GDR, the Czechoslovak restitution plan was the largest put into effect in Eastern Europe.⁷

b) The First Restitution Act

(1) Content

The First Restitution Act was approved on October 2nd, 1990. It authorizes the return of any property that was expropriated by the communist regime between 1955 and 1959 to the original owners or their successors.⁸ The act covered only a small part of the private property confiscated by the communist state, consisting mostly of small service establishments (e.g. shops and restaurants).⁹ The First Restitution Act stipulated that compensation (usually in the form of low-interest bonds) could be granted only if the return of the property was not practicable due to the property's destruction or irrevocable modification through use.¹⁰

(2) Procedure

Citizens of Czechoslovakia were entitled to file claims prior to May 1st, 1991 for their confiscated properties. The same was true for non-citizens,

⁵ Frydmann, et al., *The Privatization Process in Central Europe* (1993), page 76.

⁶ See note 1, pages 69-70.

⁷ Mladek, *The Different Paths of Privatization: Czechoslovakia 1990 - ?*, *PRIVATIZATION IN THE TRANSITION TO A MARKET ECONOMY: STUDIES OF PRECONDITIONS AND POLICIES IN EASTERN EUROPE* (John S. Earle et al. eds., 1993), pages 121, 126.

⁸ See note 2, page 411.

⁹ See note 2, page 411.

¹⁰ Pechota, *Privatization and Foreign Investment in Czechoslovakia*, page 310.

however their ability to do so was limited by the existence of a relevant bilateral treaty between Czechoslovakia and their country of residence.¹¹ Furthermore, any enterprise or organization that originally owned confiscated property, had to enter into contracts with individual claimants in order to prove their titles and thus to recover their assets.¹²

c) The Second Restitution Act

(1) Content

The Second Restitution Act, which was adopted on February 21st, 1991, provided for the return of confiscated property. With its total budget of \$10.7 billion,¹³ it represents the largest transfer of wealth in history. Compensation was granted only if returning the property in kind was not feasible. The Second Restitution Act allowed for the return of private property nationalized, confiscated or otherwise expropriated during the period from the communist takeover on February 25th, 1948 to the end of 1989.

(2) Procedure

The Second Restitution Act was applicable on individuals only, with an explicit exclusion of companies.¹⁴ Under the Second Restitution Act, the current owners, which were normally state enterprises or municipalities, were forced to return the appropriate property deeds to the original owners. Arising disputes were dealt with at court. In those cases, where property could not be physically restituted, approximately \$750 million were assigned for cash compensation to the original owners or their heirs, with the balance of such compensation being paid in government-issued bonds.¹⁵

¹¹ See note 2, page 411.

¹² See note 2, pages 411, 412.

¹³ See note 2, page 412.

¹⁴ Glick, Richter, *Legal Framework for Privatization in Czechoslovakia*, in *INTERNATIONAL BUSINESS LAWYER* (11/1990), page. 442, 444.

¹⁵ See note 2, page. 412.

(3) Privileges of Czech citizens

Benefits under the Second Restitution Act were granted to resident citizens of the Czechoslovak Republic only. Czechoslovaks permanently residing abroad and foreign nationals did not qualify for restitution.¹⁶ Czechoslovakia instituted a system in which citizens of Czechoslovakia were the primary beneficiaries who consequently retained ownership of their property and were satisfied with the process. Despite political controversy over whether to expand restitution to persons living beyond the Czechoslovak border, the government maintained its policy.¹⁷ This had the result that Czechoslovak restitution progressed relatively smoothly and at the same time embodied the fastest method of privatization within Czechoslovakia.¹⁸

(4) No restitution for expropriation between May 1945 and February 1948

Excluded from the benefits of restitution was property nationalized or confiscated between May of 1945 and February of 1948¹⁹, though certain limited exceptions existed. In continuance of legislation, this law additionally does neither apply to state-owned agricultural cooperatives nor to property confiscated from religious organizations after February of 1948.²⁰

(5) Conditions for restitution claims

According to Czechoslovak laws, before a state company could be privatized, the records of the registry of deeds had to be examined to find out if there was a private owner of the enterprise prior to 1948. If this was the case, the privatization action had to be deferred until six months after

¹⁶ See note 10, page 311.

¹⁷ See note 5, page 77.

¹⁸ See note 1, page 72.

¹⁹ See note 7, page 122.

²⁰ See note 10, page 310.

the effective date of the relevant Restitution Act.²¹ The privatization of the state enterprise was allowed to proceed only without valid claims of former owners during this time period.²²

d) The initial demand and the effects of the Czechoslovak restitution

In October 1990, a survey of the Czechoslovak State Institute of Public Opinion stated that one out of every four citizens planned to file an ownership claim in order to re-obtain expropriated property.²³

The Czechoslovak government created a strict set of rules which was still sufficiently flexible so as to not call for amendments throughout the entire process. Also, by designating monetary compensation as a preferred or at least equal method for restitution, the persons responsible for privatization would maintain opportunities for foreign investment. Thus, while restitution progressed relatively smoothly, investments in Czechoslovakia were not slowed down.²⁴

2. Small – scale privatization

The persons responsible for privatization in Czechoslovakia chose the "Big Bang" approach to mass privatization.²⁵ Privatization through sales to private persons and restitution of seized properties were included in the privatization process.²⁶ In addition, the Czechoslovak privatization scheme combined a multitude of methods that created opportunities for the Czechoslovak citizens to take part in the transformation of their country's economy.²⁷

²¹ See note 2, p. 412.

²² See note 10, page 312.

²³ See note 2, p. 412.

²⁴ Stack, *The "Colonization" of East Germany?: a Comparative Analysis of German Privatization*, 46 DUKE LAW JOURNAL, p 1243.

²⁵ See note 24, page 1243.

²⁶ See note 1, pages 68 – 69.

²⁷ See note 5, pages 80 – 81.

After restitution, small-scale privatization represented the second major privatization method; it was mostly put into effect by means of auctions.²⁸ Small stores, enterprises, and services were auctioned to the public. Compared to other citizens, the current owners or managers of these places did not enjoy any advantages in these actions. Most citizens appreciated this policy and grew loyal to market reform and the new government. Furthermore, the fact that the new owners had large personal stakes in the small businesses they purchased gave them even more an incentive to succeed.

3. Large – scale privatization

The third way of privatization in Czechoslovakia was large-scale privatization: the sales of large state-owned enterprises were organized by means of a flexible combination of methods, applying the voucher privatization method as well as direct sales.²⁹

a) Direct sales

Due to the fact that citizens of Czechoslovakia had the chance to invest, they were most involved in direct sales of assets. Citizens paid the book value for enterprises, whereas foreign individuals or companies had to pay the market value, which was usually much higher.³⁰ The different treatment of citizens and foreigners led to an increase in internal investments in Czechoslovakia.³¹ Thus, the Czechoslovak government protected its country from foreign investors that might have played too dominant a role in the transformation process. Instead, the Czechoslovak citizens could maintain ownership in their country.

²⁸ Peric, *Privatization and Competition Policy in Eastern Europe*, BOLETÍN LATINOAMERICANO DE COMPETENCIA NO. 15 (2002), page 184.

²⁹ See note 1, page 73; Bolton, Roland, Vickers, Burda, *Privatization Policies in Central and Eastern Europe*, in *Economic Policy* 1992, page 283.

³⁰ See note 5, page 81.

³¹ See note 24, page 1244.

b) Voucher privatization

(1) The method

Other than direct sales, the Czechoslovak privatization scheme also consisted of voucher privatization, which is sometimes described as "popularizing privatization"³². During this process, shares of privatizing companies are sold to citizens.³³ For an administrative fee of about \$ 34, citizens of Czechoslovakia were offered to purchase a booklet of investment coupons, which in turn could be exchanged for shares in newly privatized companies.³⁴ In 1993, after the first round of privatization, more than 8.5 million people had bought stock.³⁵

(2) Reasons for the application of voucher privatization

The government had several goals for the application of voucher privatization:

(i) Higher efficiency of the companies

The most obvious was to take enterprises out of the hands of the government and sell them to those who would be able to make them most productive.

(ii) Taking power from the nomenklatura

It was of great significance for the new Czechoslovak government to prevent the nomenklatura (the former communist leaders and company officials³⁶) from staying in control of companies.

³² Schmiedling, *Alternative Approaches to Privatization: Some Notes on the Debate*, in PRIVATIZATION (Horst Siebert ed., 1992), pages 95, 106.

³³ See note 5, pages 83 – 85.

³⁴ See note 5, page 84.

³⁵ Pehe, *Czechoslovakia: Toward Dissolution*, Jan. 1, 1993, page 84, 87.

³⁶ Brada, *Privatization is Transition – Or is it?*, in *The Journal of Economic Perspectives* 1996, page 67.

(iii) Prevention of foreign capital domination

The third goal was to keep non-citizens from dominating the process of privatization. Considering the financial strength of many foreign companies or private individuals, it was not in the interest of the Czechoslovakian government to participate foreign investors in the voucher privatization. The risk would have been too high that some of them might have purchased the country's most valuable enterprises.

(iv) Chances for basic restructuring

The set up of most companies that were offered through the voucher plan was geared towards the standards of planned economy. In order to deal with the challenges of market capitalism, almost every enterprise needed fundamental restructuring. The new Czechoslovak government thought of voucher privatization as the tool that would enable the new owners to force the existing management to make necessary changes, thus allowing an increase in productivity and profitability.

(v) Introducing citizens to investing

By means of the voucher privatization, the new Czechoslovak government also intended to introduce citizens to investing. It was expected that the voucher scheme would lead to the transformation of more household savings into domestic investment. Especially in this respect, the use of the voucher system as a whole was largely inevitable. The political realities of the time forced mass participation in the transition process. Voucher privatization was the only system that would have satisfied this demand.

(vi) Quick establishment of property rights

Furthermore, the quick transfer of assets did establish property rights.

(3) The role of Investment Privatization Funds within the voucher privatization³⁷

One of the major concerns in regards to voucher privatization was its potential to create too wide a distribution of shares in the newly privatized companies. This would have led to a control vacuum and thus prevented the necessary changes made in structure and management of many enterprises. To prevent this, the Czechoslovak government allowed the participation of Investment Privatization Funds (IPFs). The people could transfer their voucher points to these financial intermediaries, which would then aggregate the capital that was distributed to the people and bid on behalf of their investors.³⁸

An individual IPF was not allowed to purchase more than 20% of the shares of one company.³⁹ Also shares of one enterprise could not make up more than 10% of the portfolio of each IPF.⁴⁰ There were 264 registered IPFs participating in the first round⁴¹, most of them getting only a small number of voucher points in the beginning. However, the largest fourteen IPFs controlled 55.5% of all voucher points in the first wave of voucher privatization.⁴² Of the total voucher points, 72% were allocated to an IPF.⁴³ It seemed that the government had underestimated the dominant role that IPFs would come to play in the process of voucher privatization.

Although many of the IPFs misused their power and have not fulfilled the expectations of the government, they may have helped in the area of establishing property rights. The voucher plan quickly privatized large amounts of the state holdings. The speed of this process prevented the

³⁷ Bolton, Roland, Vickers, Burda, *Privatization Policies in Central and Eastern Europe*, in *Economic Policy* 1992, page 284.

³⁸ See note 36, pages 72, 73; See note 7, page 131.

³⁹ Fitzsimmons, *Investment Privatization Funds, Banks and Corporate Governance in the Czech Republic and Russia*, in Chazen Web Journal of International Business 2002, page 3. www.gsb.columbia.edu/chazenjournal

⁴⁰ See note 39, page 3.

⁴¹ See note 39, page 3.

⁴² See note 36, page 73.

⁴³ See note 36, page 73.

asset stripping that was common for companies that were waiting to be sold to new owners.

III. Final overview

As a result of the Czechoslovak privatization process and compared to other transition countries, the citizens of Czechoslovakia were well prepared for transformation and had more invested in the privatization process. Especially the voucher privatization method allowed citizens to have a stake in the newly established market economy; on the other hand, citizen entrepreneurs are now "fiercely loyal to Prague's democratic government."⁴⁴

Considering its flexibility, the privatization process in Czechoslovakia progressed rather quickly. In 1993, less than two years after the Privatization Act was adopted, privately owned real estate and companies accounted for sixty percent of Czech property.⁴⁵ The transformation process provided for the successful transfer of ownership into private hands. At the end of 1995, almost eighty percent of the Czech Republic's GDP came from the private sector.⁴⁶

⁴⁴ Rutland, *Privatization in East Europe: Another Case of Words that Succeed and Policies that Fail?*, TRANSNAT. & CONTEMP. PROBS. (1995), pages 1, 12.

⁴⁵ See note 24, page 1245.

⁴⁶ *Prague Transformed*, THE ECONOMIST, Nov. 18, 1995, pages 17, 19.