The Transformation of the Property Regime in Croatia and Slovenia

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A thesis submitted for the degree of Doctor of Philosophy of The Australian National University

November 2009
Declaration

I certify that this dissertation is product of my own work and that to the best of my knowledge all sources used have been properly acknowledged.

[Signature]

Ella Zalmov
Acknowledgments

From 2006 to 2009 I attended a number of philosophical seminars at the Australian National University. The method of analysis and discussion, which differs from the form of discussion that prevails in the seminars of continental philosophy, was revealing to me and refreshing; this helped me to sharpen the discipline and consistency of my investigation.

However, a constant discussion with my supervisor Jeremy Shearmur, his objections and positive criticism of my ideas, contributed to the improvement of my research more than anything else. I do not want to exaggerate, but I do not have adequate words to express my gratitude to Jeremy’s persistence in getting me to refine my ideas and to explain how much I appreciate his patience in the improvement of my English writing. Particularly important were Jeremy’s explanations as to how a reader might interpret my insights and conclusions, which would be against of my original intentions. Jeremy’s advice as to how to avoid the trap of ideological interpretation were really invaluable.

It was a great encouragement for me when Geoff Brennan, a member of the panel, supported my choice of a property rights approach and later advised me how to sharpen my explanation without going into unnecessary digressions. Contrary to my belief that I was fully familiar with the history of self-management in the former Yugoslavia and with the process of privatisation, Robert F. Miller helped me to fix mistakes and introduced me to important facts about socialism across Eastern Europe. I would like to thank my friends from Croatia, Slovenia, Bosnia and Herzegovina, Sweden, Australia and the USA who supported my investigation, provided me their opinions and helped me to collect sources and literature.

However, there is no market which could value the support that I received from my family, my wife Marija Legat, and my children Franc, Jura and Veno. This thesis is dedicated to them and to my parents who passed away shortly before I concluded my work.
Abstract

The transition from socialism in Eastern Europe during the last decade of 20th century could be rightly observed and analysed as a chapter of the great battle between ideologies such as liberalism, libertarianism, socialism and communism, or as a competition between the political programs of liberal democracy, social democracy, orthodox socialism and so on. Both politics and ideologies use such terms as a “free market” or “fair trade” routinely. In contrast to this approach a philosopher doesn’t take these ideas for granted; “freedom” in “free market” and “fairness” in “fair trade” are complex concepts that should be analysed, their meaning put in a context, understood and explained.

The same is true of notions of property, private property as opposed to public property and of the definition of a competitive market. These concepts are the subject of my research; how the ideas of property and market were understood and implemented during the process of transformation of socialism in Croatia and Slovenia.

The intention of this research is to be a positive analysis of the transition in Slovenia and Croatia. My criticism that the distinction between private and public property was not entirely adequate in the context of transition, doesn’t imply that the process of privatisation of socialist property should have been avoided. Rather I found that the distinction between private and public property was analytically less adequate than the distinction between individual and collective property and open access for the explanation of the transformation of the property regime inherited from socialism (self-management) in Croatia and Slovenia. This later distinction was based on the concept of the costliness of property, which was initiated by the work of Ronald Coase and developed by Yoram Barzel. The concept of the costliness of property enabled me to conclude that privatisation in Croatia shared some substantial characteristics with initial appropriation of nobody’s
property and to understand why ownership arrangements with a dominant shareholder were favoured. Privatisation in Slovenia represented an evolution of a property regime while the dispersed shareholding that included employees and former employees was preferred.

The finding that the exchange of goods and services is influenced by an implicit norm of behaviour (customary norms, or moral norm or even legal norms) and the insight that exchange would even fail to occur without an implicit assumption of norms on the part of all sides in an exchange, doesn’t amount to the imposition of a universal absolute norm of “fair trade” by the government. This would be an ideological interpretation of my arguments.

The development of market institutions depends on numerous factors and influences, ideologies and political programs among them. My description of the transition in Slovenia and Croatia takes into account the influence of interest groups, political parties and also the ideologies which they used to legitimise their intentions. However, my focus is on two theoretical explanations, the neoclassical and the property rights explanation of a market economy that contributed to the formulation of the policies of privatisation in Croatia and Slovenia and participated in the creation of expectations about what would follow from future arrangements.

Although I believe that my conclusions are clear and precise I feel obliged to emphasise that the criticism of neoclassical view is by no means a plea for governmental regulation as a solution for shortcomings of a particular market. Rather, I would like to point to the need to take institutions, traditions and cultural factors seriously and also that the adequate functioning of a market economy itself depends on institutions and cultural factors.

Therefore I expect that my thesis, over and above its value as a detailed treatment of privatisation in Croatia and Slovenia, should be a contribution to the understanding of basic concepts of property and market and to the explanation of the development of market institutions.
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Chapter I

Privatisation and the transition from socialism: two approaches

The transition from socialism to capitalism, an extraordinary social experiment in Eastern Europe during the last decade of the 20th Century, has so far been analysed mostly by political scientists; while economists have calculated the effects (IBRD/WB 2005; Estrin 2001). This investigation into the transition in Croatia and neighbouring countries, primarily Slovenia, uses the framework of a theory of property. The selection of the framework seems reasonable: privatisation, that is, the changing of the property regime, was considered a cornerstone of the transition. The distinction between private and public (collective) property was viewed as essential for the differentiation of capitalism from socialism. Postsocialist reformers and their supporters from intellectual circles emphasised the importance of the transformation of the property regime for economic and political change. Therefore, if the transformation of the property regime was seen to be crucial for the transition from socialism, the idea is to investigate: (1) how the existing socialist forms of property and market were understood (described); (2) what was the idea of a future property regime; (3) how the programs for the transformation of property regimes in Croatia and Slovenia reflected (1) and (2): I will here consider both the understanding of the past regime and the concept of the future property regime; (4) what really happened with respect to property and its institutional environment.

Privatisation in the countries of Eastern Europe is often seen as a continuation of the wave of privatisation that started in the UK in the 1980s (Meggison, 2005, p. 4). An overall positive assessment of privatisation in the UK was taken as

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1 As a preparation for the analysis of privatisation in Croatia and neighbouring countries I studied British privatisation. I have produced the chapter "Privatisation in the UK", which I am not including in this final variant of the thesis. I will draw upon this work in discussing the context of privatization in Croatia, not least because those involved in Croatia often referred to events in Britain, in the legitimation of their approach (Kalogjera 1990, p. 154).
reaffirming and reconfirming the principles of neoclassical economics\(^2\) (Gamble, 1988; Bosanquet, 1984). It is widely accepted that initially, at the beginning of the 1990s, “neoclassical economics provided the general framework” for the transition from socialism (Pejovich, 2006, p. 233). I argue that the transformation of the property regime in Croatia indeed fits into the neoclassical understanding how a market economy emerges and how it works, while the process of institutional change in Slovenia looks as if the insights of the economics of property rights were seriously taken into account. The following quotes illustrate this point.

### 1.1 Two quotes

At the beginning of 1991 the Institute of Economics Zagreb organised a discussion on privatisation and the transformation of the socialist property regime. Subsequently, the findings of leading Croatian economists were harmonised and published in a volume that was entitled *Privatisation in the Policy of Economic Development* (PPED 1991). Several of the participants in the discussion were to become ministers responsible for the economy, privatisation and restructuring and some participants were already members of the Croatian government. The academics overwhelmingly advocated that collectively owned and administratively managed firms were to be speedily allocated to individuals and private companies. The scenario assumed that the setting up of private property necessarily initiates a swift establishment of a capital market, regardless of whether market institutions, for example the stock exchange, have already been created or whether trade occurs in banks, or even without intermediaries. One may expect that shares come into the hands of those who are interested in the success of a company, into the hands of so called ‘active investors’. (PPED 1991, p 59, my translation from the Croatian)

The above picture expresses the particular understanding of how a market economy works, of its genesis and growth that was dominant in Croatia throughout the process of transition from socialism. Economists in Slovenia, which is a neighbouring country to Croatia, were not so confident about the path of transformation of a socialist property regime. Joze Mencinger, a university

\(^2\) My interest here is an investigation into property, the market and their relationship. Neoclassical economics, in my understanding, basically assumes decentralised ownership and the market as it was described by general equilibrium theory. However, it could be challenged whether all of those in the UK who advocated privatisation shared this understanding of market. Nevertheless, I think that the process of privatisation in the UK strengthened the influence of neoclassical economics, which dominates mainstream economics today.
Formally, market institutions that exist in developed market economies could be established by decree. Many politicians in Eastern and Central Europe are more than willing to copy such institutions from the West. However, it is highly unlikely that these institutions would operate in transforming countries [in] the same way as they do in the developed market economies. The performance of market institutions crucially depends on norms and patterns of social behaviour created by the institutions of civil society. According to Hare (1991, p.3) ‘the successful operation and management of a market-type economy is, to a surprisingly large extent, a confidence trick’. Agents taking part in economic transactions repeated or adapted to changing circumstances, must believe that everyone else behaves [in accordance with] the principles of the society; rather little can be governed by formal rules and contracts. The absence of norms and patterns of appropriate social behaviour appears to be the most important impediment of transition in Eastern and Central Europe. This might further delay the efficiency improvement from privatisation... (Mencinger, 2001, emphasis in the original)

1.2. Two theories

In my opinion the quotes clearly express two distinctive approaches to the transition from socialism. The first one briefly formulates an understanding of how the market economy emerges and how it works as is developed within the framework of neoclassical economics. A program of transition from socialism, which has been called the Nirvana scenario, follows this interpretation of the genesis of the market in the West (Collombato and Macey; 1997). The formal recommendations of the World Bank as to how to reform socialist economies and a set of prescriptions, known as the Washington consensus (Williamson 1994; Williamson 2004), resemble the same model. At the end of chapter II (section 4.3) the Nirvana scenario is briefly criticised, but the main content of chapter II is an analysis of the key concepts that underlie the neoclassical program for the transition from socialism. Chapter II explores the traditional concept of property, of what makes for ownership and of what marks the distinction between private and public property (section I).
The neoclassical understanding of a market economy assumes the existence of decentralised property. In addition, the problem of privatisation relates to a second issue. A traditional subject of the theory of property is initial appropriation: how property came about. That is, if the neoclassical model faithfully reflects how the market economy works, the problem of the genesis of property, which is a genuine problem of privatisation, arises. In section 3 of chapter II particular characteristics of initial appropriation that were commented on by John Locke are discussed, since - in subsequent chapters - I argue that the discussion about the process of privatisation in Croatia bears some important resemblances to a Lockean discussion about initial appropriation. The final sections of chapter II analyse the relationship between privatisation and ownership, the distinction between public and private property and initial appropriation. At the end of chapter II initial appropriation is analysed from the position of the economics of property rights which concludes that initial appropriation – as it was described there (Lueck 1995) - leads to the dissipation of resources. I would like to emphasise here the distinction: the process of privatisation in Croatia shares some characteristics with initial appropriation as it was defined by Waldron (1988) and analysed by Lueck (1995) while the discussion on privatisation in Croatia resembles Lockean discussion about initial appropriation.

The second quote above is an example of a criticism of the neoclassical program from the position of a developed variant of the economics of property rights: the distinction between formal and informal market institutions and the distinction between legal and economic rights are implicitly assumed in the quote. I would like to emphasise that the term “the economics of property rights” as used here includes not only the early analyses of the economic aspect of property rights conducted by Ronald Coase and others, but also law and economics research, and insights provided by the information asymmetry model and particularly the new institutional economics. The economics of property rights stemmed from a critical analysis of the neoclassical paradigm, which commenced long before the start of the transition from socialism. When some countries under transition failed to fulfil expectations that were projected by the neoclassical framework this further added to the criticism of the neoclassical paradigm (see Pejovich 2001, Vol II, Part III).

As is the case for chapter II, which doesn’t provide a complete description of neoclassical economics but simply raises some questions concerning its

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3 References that detail of all of this are provided in the following chapters.
fundamental concepts, chapter III introduces basic ideas and principles of the economics of property rights, because in my view these concepts will be useful for understanding the transformation of the socialist property regime. The economics of property rights represents an alternative understanding of property to the traditional one, which is described in chapter II.

As a starting point, transaction costs and what I will refer to as the costliness of property are described (chapter III, section 1.1). The origins of property rights economics in the work of Ronald Coase are explained (section 2). The Coase Theorem and exchange under the condition of zero transaction costs are analysed. I argue, to some extent controversially, that the world of zero transaction costs (the world of the general equilibrium view of the market) does not depict a world that is an idealisation of the real world of positive transaction costs; these two worlds are guided by different principles of exchange.

The two understandings of the market disagree about the question of what are transaction costs and whether transaction costs are exogenous or endogenous to market exchange (Allen, 1999). In the neoclassical case, transaction costs only more or less disturb market exchange in the real world; much as air resistance slightly disturbs gravitational force in the case of free fall but it does not cause the changes in the law of gravitation. In this theory the general equilibrium understanding of the market is analogous to the law of gravitation, while transaction costs play the role of friction.

In the view of the economics of property rights, transaction costs are an essential characteristic of property; therefore they cannot be abstracted from the principles of market exchange. Actually, transaction costs and the costliness of property are constitutive of market exchange. If transaction costs are endogenous to market exchange then the neoclassical assumption of a zero transaction costs world (Walrasian economics) is intrinsically inconsistent (Barzel 1989, p.9). One of the numerous consequences of the idea that property is what I refer to as ‘costly’ is that the initial allocation of resources matters and this issue was important.

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4 The question whether transaction costs are intrinsic to the market exchange or not is sensible only if transaction costs significantly disturb this allocation of resources which was predicted by general equilibrium theory. I.e. someone can take the view that, say, friction is intrinsic, but say that nonetheless we should not bother with it, because the effects are small. However, the motive of my investigation was that the deviation from the path of what was to be expected on the basis of a neoclassical understanding of the market wasn’t insignificant. Than the question whether “friction” (the costliness of property) is intrinsic to market exchange or not is not unimportant. This problem is further discussed in chapter III.
in the process of privatisation and transition from socialism; more specifically, the assumption of Croatian economists (the first quote above) that if assets are privatised they shall (implicitly, regardless of what institutions are set up) sooner or later come into the hands of ‘active investors’ is wrong.

Key questions addressed in this research are the evolution of property regimes; why property regimes develop and why institutions (of exchange and of appropriation) emerge at all. From the perspective of property rights economics the answer is the costliness of property. I would like to emphasise that the term “institutions” follows North’s (1990, chapter V - Institutions) description that includes formal and informal rules of conduct that influence the allocation of resources. That is, along with direct governmental intervention and laws, a distinctive economic culture consists of institutions such as customs, moral norms, beliefs, ideologies and theories that represent constraints upon and create incentives for market exchange; they are embodied within economic activity; they enable it. This is why the transfer of economic culture from one society to another one is not always successful (cf. the second quote above). The emergence of institutions of exchange and appropriation as a consequence of a fundamental costliness of property is analysed in chapter III, section 2. 4 – A short presentation of Coase’s examples, and in section 3.1 – Markets with costly property rights.

The second part of chapter III (from section 4 onwards) introduces some applications of the basic concepts of the economics of property rights. Section 4.1 explains that property rights economics puts the distinction between public, collective and private property on a different footing than does neoclassical economics. A tendency towards the concentration of ownership (majority shareholding) was noted during the transition. A theoretical framework that defends this tendency is introduced. Theoretical insights from the evolution of property regimes and their relationship to the transition from socialism are introduced in the final sections of chapter III.

1.3 Two paths

The comparison of market-oriented reforms in Croatia and Slovenia is facilitated by the fact that both were parts of the former Yugoslavia, both inherited a distinctive system of workers’ management and the first steps of privatisation in both countries were similar. The processes were triggered by a massive distribution of shares to workers, citizens and financial organizations. Further
paths of transformation - particularly the development of financial markets - significantly diverged.

The property regime in Croatia and Slovenia, before privatisation, was called self-management and social ownership (chapter IV). Companies were not directly managed by the government. Self-management is a variant of employees’ cooperatives, a structure well known in capitalism. Social ownership was similar to regulated common property. That is, workers managed the firm but the community\(^5\) exercised control to make sure that resources wouldn’t be dissipated or destroyed. Workers didn’t have the right to sell their company. Some people interpreted the arrangement as being that workers rented the company from the community, but the community had the right to take the assets back only in the case of bankruptcy. It is worth noting that the experiment with self-management was an important subject of investigation by the economics of property rights from its early days (Pejovich 1966; for further references see chapter IV, section 1.2 The myth of self-management). Chapter IV describes the development, performance and characteristics of this unique property regime.

Some forms of workers’ management were introduced in other socialist countries in the 1980s (in Poland workers management was introduced already in 1956, but to a limited degree). Therefore, the present research into the transformation of self-management might be fruitful for the understanding of transition across Eastern Europe. In the former Yugoslavia, of which Croatia and Slovenia were federal units, this property regime started in 1950. In the 1980s it was concluded that social ownership and self-management were inefficient, and that they needed to be transformed.

The Croatian privatisation debate (Chapter V) produced three different opinions about the character of this property regime. According to the first one, social ownership was actually public ownership; according to the second, self-management already represents private property; the third opinion was that this was not ownership at all; the assets of these companies were seen as nobody’s property.

The strongest argument of those who claimed that self-management and social ownership were nobody’s property was that their assets shared a destiny

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\(^5\) “Community” usually meant a local, regional or national body of which members were representatives of unions, youth organisations, war veterans, business, but with the leading role reserved for the League of Communists (the Party); the details will be discussed in chapter IV.
similar to the so-called tragedy of the commons (Hardin 1968). Resources were overused, neglected, badly managed and suffered from under-investment. There was a widespread and very influential rhetoric, which required a reform of the property regime, such that the new owner should take full responsibility for the performance of the company. In consequence, the no-ownership rhetoric, which denied that anybody was the owner of these resources under a socialist property regime, opened the door for privatisation to take the form of initial appropriation. Chapter X summarises the effects of the rhetoric that social ownership was nobody’s property. I argue that privatisation in Slovenia took the form of the evolution of a property regime because of different attitudes towards self-management. In my opinion, the peculiarity of the property regime of the former Yugoslavia and its transformation creates the opportunity to research the basic concepts of property and markets, of what makes an owner and what the distinction between public and private property amounts to.

The characteristics of Croatian and Slovenian economic cultures and their transformation are explained in chapters VI - IX. The description of the processes of privatisation in both countries is divided into two parts. The first part explains the initial allocation of shares to employees and citizens. At first sight the method used for the distribution of assets in the two countries may appear to be similar, but a thorough analysis discloses how the processes of privatisation in both countries were affected by the distinctive natures of the Croatian and Slovenian political regimes. Consequences of the authoritarianism of the Croatian political regime of that time are described in detail. By contrast the Slovenian political regime could be characterised as pluralistic. Support for the process in Croatia was facilitated by side payments to political client groups: war veterans, former political prisoners, former political emigrants and so on. In Slovenia, the process of privatisation was designed after a long-drawn-out but consensual discussion involving a wide range of interest groups.

The development of financial markets in both countries substantially diverged. Chapter VII describes how characteristics of the Croatian financial market, which I described as “a market without price information”, favoured the concentration of ownership in the hands of privileged insiders. Particular scrutiny in chapter VII is devoted to the development of the banking industry and the privatisation of banking. The following fact illustrates how this process was atypical: In 2005 the Croatian Parliament requested a report on the privatisation of the banking industry from the Croatian National Bank (CNB Report 2005), since people
did not understand how the banks were privatised without a formal program of privatisation, while the Law on the privatisation of companies had excluded the banking industry. As for the relationship between the financial market and privatisation, chapter VII analyses the outcomes of the massive distribution of shares to employees and citizens. One of the consequences of the design of the process was that a large proportion of individual shareholders abandoned their holdings and gave up on participation within what was a non-transparent market. The problem concerning which moral principles underlie such a design of a financial market is also analysed. Chapter VIII describes how the same problems were resolved in Slovenia. The concluding chapter X argues for the main hypotheses of this research, that the process of privatisation in Croatia resembled an initial appropriation, while in Slovenia the process of privatisation was an example of an evolution of a property regime.
1.4 Two models

I have systematised two models (presented in Table 1) based on two competing theories of how a market economy works and on the insights that they offer into the processes of privatisation in Croatia and Slovenia.

<table>
<thead>
<tr>
<th>Neo-classical view of market economy</th>
<th>The economics of property rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Emphasis on property as a factor of production</td>
<td>The distinction between property and property rights</td>
</tr>
<tr>
<td>2. Costliness of property neglected</td>
<td>Emphasis on the costliness of property rights</td>
</tr>
<tr>
<td>3. Property rights reduced to legal rights</td>
<td>The distinction between economic and legal rights to property</td>
</tr>
<tr>
<td>4. Unified ownership</td>
<td>Decomposition (disintegration) of property rights</td>
</tr>
<tr>
<td>5. Transaction costs <em>exogenous</em> to the market</td>
<td>Transaction costs <em>endogenous</em> to the market</td>
</tr>
<tr>
<td>6. Neglect of market institutions</td>
<td>A market created by institutions</td>
</tr>
<tr>
<td>7. The market as an auto-regulating mechanism</td>
<td>An efficient pricing mechanism has to be created</td>
</tr>
<tr>
<td>8. Initial allocation of resources neutral</td>
<td>Initial allocation of resources matters</td>
</tr>
<tr>
<td>10. Private ownership of a firm identified with having a dominant shareholder</td>
<td>Private property in a number of forms</td>
</tr>
<tr>
<td>11. A sharp public–private distinction in regard to ownership</td>
<td>Combined individual-collective ownership</td>
</tr>
<tr>
<td><strong>12. Privatisation took the form of an initial appropriation</strong></td>
<td><strong>Privatisation represents the evolution of a property regime</strong></td>
</tr>
</tbody>
</table>

The first four rows of the Table 1 introduce distinctions between two theoretical concepts in regard to property rights. The next four rows indicate differences in regard to the market. The concepts of ownership of companies diverge as well. Finally, I have indicated that the process of privatisation in Croatia took the form of
an initial appropriation, while in Slovenia it represented the evolution of a property regime. It is worth noting that the distinction in row 10 follows probably less from the theoretical divergence than from policy preferences in each particular country. The problem of the concentration of ownership is one of the important subjects of this research. Though there were hypotheses that the classical capitalist firm with concentrated ownership rights fits best into a deregulated market economy, no less persuasive is the finding that the neoclassical framework is open to a whole spectrum of ownership forms. The demand for concentration of ownership was part of both the theory and the policy of privatisation in Croatia and it is possible to find traces of this in Slovenia and other Eastern European countries, even in the recommendations of the World Bank. However, Western economies recognise different ownership structures; hence: the concentration of ownership is less a theoretical demand within the neoclassical framework than the product of a policy decision. It will be investigated whether the outside circumstances determined the choice of approach to privatisation, whether the approaches were chosen because of theoretical preferences of decision makers or whether the decision-makers followed their particular material interests.

2. Preliminary comment

The content of the chapters was briefly described above and the main hypotheses were explained. In the second part of this chapter (which follows) I will provide a general comment about alternative explanations of the transition from socialism and the transformation of the socialist property regime. I will try to clarify the relationship between my interpretation of these changes and the interpretation that emphasises the socio-political aspect of transition (Slantchev 2005). For example, differences in the social structure and political regimes in Croatia and Slovenia were commonly understood as the causes of the divergence of the paths of privatisation in the two countries. My approach is different: it is primarily focused on the relationship between the real process of privatisation on one side and - on the other - the theory of property and market that was used to justify privatisation policies in Slovenia and Croatia or to explain the changes.

These two approaches are not necessarily in conflict; it is possible that socio-political sphere and the choice of privatisation doctrine in the two countries were somehow connected. It might be that the dominant political actors (parties, unions, powerful groups) in Croatia and Slovenia advocated and imposed a particular method of privatisation because it fitted their interests. In this case
the characteristics of the political regime (authoritarian, democratic or pluralistic) might be important for the choice of the path of privatisation. Nevertheless I think that the investigation into the real changes of property regime and the theories that supported them is necessary for a comprehensive understanding of the transition from socialism, even if the social and political characteristics were decisive. Finally, the advocates of the transition emphasised the transformation of the property regime (privatisation) as a crucial for an overall socio-political transformation. The following brief analysis of an intricate triangle: (1) ideas – (2) politics – (3) economy may be helpful for the understanding of the focusing of this research on the relationship between the theory of property and market that was in the background of the programs of reforms on one side and the real development on the other.

I am aware and the reader should note that the sides of the triangle are vaguely denoted. Politics (2) covers the political system, political actors and policies. In addition to theories of property and market, ideas (1) may include ideologies and policy programs. Political actors may accept particular ideas and rely on them as such, but an important feature is that theories create expectations about the benefits and disadvantages of a particular (economic) system that will fall on different individuals and social groups. Finally, the economy (3) comprises both the economic system and economic development; the system of production and distribution of goods on the one side, and – on the other – the changes in this system. This vagueness simply reflects the complexity of the process of institutional change. From this imprecisely defined triangle, the following analysis selects particular specific concerns that were relevant for privatisation in Croatia and Slovenia.

The first issue to be commented upon is: Does the character of the political sphere affect the choice of the path of privatisation; if yes - how? Is there a necessary relationship between the political (2) and economic sphere (3); between the nature of the political regime and the path to privatisation? Then the next angle within the triangle will be described, i.e. the one between ideas (1) and interests (2). In this relationship it is important to note the role of experts.

The relationship between economic development (3) and the nature of the economic theory (1) concludes the third angle of the triangle. The economics of property rights is mostly a descriptive theory of economic development. By contrast, neoclassical doctrine emphasises its own predictive power; therefore it
might be used, and it is frequently used, as a normative theory. The distinction between prescriptive and descriptive nature of the two theories was certainly of significance for the choice of programs concerning how to create a functioning market economy. Additionally, neoclassical economics explains how a market economy works and implicitly assumes how it emerged, while the economics of property rights was strongly concerned with the development (evolution) of economic systems. Later in the thesis I will investigate whether the distinctive characteristics of the two theories were of significance for the choice of the path of reforms in Croatia and Slovenia.

2.1 The political and economic spheres

The transition from socialism has been a twofold process that included the transformation of the political and the economic spheres; political liberalisation is usually identified with democratisation, of which the first step was multiparty elections, while the goal of economic change has been the transformation of the command economy into a system of production and distribution coordinated by market competition. Although it has been the subject of intensive research, the relationship between the economic and political spheres in general and concerning the transformation of former socialist countries remains “complex, contradictory and unresolved” (Garrad et al, 2000, p 2). I will hereafter comment on two general hypotheses about the relationship between political and economic spheres that were considered relevant for the transition from socialism.

**Hypothesis 1: The market stimulates democratisation.** It has often been advocated that democratisation and marketisation go together. Modernisation theory (Lipset 1994) assumes that decentralised and competitive economic activity, i.e. the market economy, stimulates economic growth and initiates the development of democracy. This view suggests that economic development creates independent centres of power and constrains the power of political authorities. Therefore, across Eastern Europe privatisation was seen as part of both economic and political changes; it was considered a precondition for a full and developed democracy. The readiness of political authorities to privatise was seen as a proof of their inclination towards the decentralisation of both economic and political power.

However, a number of the conclusions of this view appeared to be simply wrong. To start with, economic decline, not economic growth, in Eastern Europe
preceded and stimulated the demand for political changes. Lipset (1994) has included even this possibility, but his resulting view implies (in a manner that is hardly informative) that both economic growth and economic decline might stimulate democratic transition. There is no barrier to concluding that even a stable economy stimulates democracy; so it means that the growth of democracy does not depend essentially on economic circumstances. Wide-ranging empirical research confirms that “transitions to democracy do not become more likely when a country is more developed” (Przeworski 2004). Many economically successful regimes are authoritarian. Moreover: “Many authoritarian polities in Europe and beyond have been prepared to privatise and capitalize while resolutely refusing to democratise, or even very seriously to liberalize in anything but an economic sense” (Garrad et al, 2000, p.2). Both authoritarian regimes and democracies seek public support through economic success. It is widely accepted that the Croatian regime of the 1990s, which was considered authoritarian (Kasapovic, 2001), distributed assets to its client groups and to people closely related to the Party in power; i.e. privatisation was used to stabilise the authoritarian regime. It might alternatively be concluded that the accumulated political power was so huge that the ruling party might implement public policy through which its members and clients satisfied mostly themselves without being afraid of losing their ruling position (Breton 1978). In any case, democracy does not necessarily follow from either economic development or privatisation.

**Hypothesis 2: Democracy stimulates marketization.** The distinction between the sequence of the process of transition from socialism and of the development of liberal democracy in the West has also to be noted. While in the West economic decentralisation was seen as a cause of political liberalisation, in Eastern Europe the political reforms towards democracy preceded the decomposition of the command economy. While modernisation theory assumes that the development of the economy stimulates political liberalisation, it was concluded that in Eastern Europe democratisation would stimulate privatisation and the transition to a market economy.⁶

Historically, the relationship between democracy and private property has not been seen as so idyllic. Although he strongly advocated the widening of the right to vote, David Ricardo was cautious that it might endanger the right

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⁶ Polish reformist Leszek Balcerowicz concludes that in Eastern Europe “the transition to capitalism happened under a democratic system instead the other way around.” (Rakowska-Harmstone 2000)
to property. In a letter to Malthus, Ricardo observes: “There may be a few wicked persons who would be glad of revolution, with no other view but to appropriate to themselves the property of others…” (Ricardo 2000, p. 129) A similar understanding of the relationship between property and democracy is expressed by Classical Marxism: The poor use democracy to expropriate rich people; the rich are threatened and subvert democracy. In our own time Przeworski and Limongy emphasise that “The idea that democracy protects property rights is a recent invention and ... a far-fetched one” (Przeworski & Limongi, 1993).

The reasoning that questions the hypothesis that democracy stimulates marketization might be an explanation of the slowness of the reform of the socialist property regime in Slovenia. The long and exhausting discussion that took place there confronted proponents of labour ownership, those who expected that management buy-out would be a central method of privatisation, advocates of the concentration of ownership rights into the hands of the owners of financial capital and so on. The debate included political parties, old and new unions, the association of managers, and the Association of Nationalised Owners (the representative of the interests of those whose property was nationalised by the communist regime) (Likic Brboric 2003). As if Przeworski and Limongi (1993) had Slovenia in mind when they pointed out: “The property rights literature treats the state as the only source of potential threat [to individual property rights]. But property rights are threatened by private actors: capitalist property is threatened by organized workers.” At the very least, a democratic pluralism doesn’t necessarily support private property and the market.

There is no doubt that the implementation of socially costly economic reforms in Eastern Europe was affected by the characteristics of the political regimes in existence there. However, theory did not support the rosy expectations of the people from former socialist countries that democratisation would automatically induce the liberalisation of the economy and economic growth while the introduction of the market would strengthen democracy. The relationship between the nature of the political regime (democratic, or authoritarian) and the development of a market economy is not straightforward. Democracy may stimulate the development of a market but it also may not; an authoritarian regime may privatisate, but not necessarily. The market may require decentralised political power, but it may also favour centralisation.
2.3 Ideas and interests

The choice of the path of privatisation might be a consequence of the activity of pressure groups that advocate a policy of institutional changes which serves their particular interest. Theory presumably helps them (1) to understand what they should do to further their particular interest, but also (2) to convince other people that they promote the policy which is in interest of all. Public choice theory concludes that government - an organization that is usually considered as if it primarily protects and promotes the public good - while it moulds decisions, also gives priority to its electoral concerns over long-term public interest. It has been argued that the selection of privatisation strategies in the UK in the 1980s, under the government of Prime Minister Margaret Thatcher, which seemed committed to an increase of economic efficiency as a good for all, was greatly motivated by electoral concerns (Bishop et al 1994). Therefore, Andrew Gamble (1989) connects the relation between ideas and interests with the development of democracy. The fact that both the government and interest groups regularly promote their particular interests puts into the focus theories that they use to legitimise their proposals (of institutional change).

Ideas are frequently confronted with interests, as if the ideas (theories) promote universal values and the interest of all, while political parties, interest groups and powerful individuals advocate their particular interests. Gamble correctly concludes that the real opposition is not between ideas and interests but between different kinds of ideas; interests don’t exist in some substratum that is devoid of concepts. There is always an idea, theory or concept that has to be confronted and analysed whether it advances particular interest or interest of all. This is why I am more interested which theories were the underlying forces of privatisation in Slovenia and Croatia than who advocated them: economists, politicians or interest groups. This is why the central issue of this investigation is alternative theories of institutional development and their relationship to the real process of privatisation.

2.3.1 Experts

The position of so-called experts introduces a new momentum into the discussion about the role of ideas in policy making. Experts are supposed to advance general doctrines that are considered “as belonging to a higher order of rationality than interest” (Gamble 1989, p. 2). A number of Croatian economists who took part in the creation of proposals for economic policy and particularly, in the design of
privatisation, participated in the implementation of these programs as members of the government. However, they often complained that their ideas weren’t correctly interpreted or implemented; some of them indeed left the government citing this as the reason. Nevertheless, I have found an attractive parallelism between policy proposals that were submitted by experts, and the documents that were produced by the government. The theoretical background of the proposals is also explained below.

The Slovenian case is similar but only to some degree. The economists who was quoted above (Mencinger) and who served as the deputy prime minister responsible for the restructuring of the economy, resigned after a conflict about privatisation policy with the Prime Minister who advocated the neoclassical approach. Nevertheless, it is documented that the public discussion of Slovenian economic experts - where Mencinger’s ideas were affirmed - influenced the final design of the Slovenian privatisation program (Likic Brboric 2003, p 239-264). Though he abandoned the direct creation of the program of privatisation, Mencinger himself emphasised that the intensive “disputes from 1991-1992 were worthwhile” (Mencinger 1996, my emphasis), which confirms that his ideas were recognised. Hence, in the Croatian case I will give evidence of a parallelism between policy proposals created by experts, the background theories and the governmental documents. Though the role of experts in the Slovenian case was also confirmed it was indirect. I will comment upon below whether this difference in the role of experts in the Slovenian and Croatian cases was somehow connected with the distinction between the normative use of the neoclassical framework and the descriptive character of property rights economics.

The relationship between ideas and interests is to be distinguished from the mutual influence between the political and economic spheres that was briefly commented upon above. This is a different angle of the triangle: ideas – politics – economy; political actors may promote their economic interests and protect them through the political process. Nevertheless, they need a theoretical justification that makes that their proposals seem to be the best response to the prevailing situation. The purpose of the above brief comment about the relationship between the ideas and the interests of those who advocated them was to clear the path for discussion of the relationship between the theory of institutional change and the real process of privatisation.

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7 Prime Minister was advised by Jeffrey Sachs, an American economist
2.4 Theory and reality

My hypothesis is that the transformation of the property regime in Croatia fits into the neoclassical understanding how a market economy emerges and how it works, while the process in Slovenia looks as if the insights of the economics of property rights were taken into account. In regard to this hypothesis and to the relationship between theory and the real institutional changes I would like to remind on the issues that were already mentioned above: (1) Neoclassical economics explains how a market economy works, while the economics of property rights was mainly concerned with the development (evolution) of economic systems. (2) While property rights economics is mainly a descriptive theory of institutional changes, neoclassical doctrine is frequently used as a normative theory. (3) Property rights economics is not yet capable of creating a consistent and comprehensive policy proposals concerning institutional change (North 1993). These points initiate the following questions:

- If neoclassical economics only explains how a market economy works and not how it develops, how could it be that institutional change in Croatia fits the neoclassical framework?

- If property rights economics is a descriptive theory which is not capable of creating a consistent policy of institutional change, how could it be that the Slovenian privatisation looks as if property rights economics was taken into account?

2.4.1 Normative and descriptive theory

I will start with the point (1) that neoclassical economics is concerned with the operation of markets, not with how markets develop. Privatisation, however, is to be understood as a case of the development of the property regime; as an example of institutional change; it is much more than a mere redistribution of assets. Therefore, according to North (1993), neoclassical economics is an inappropriate tool to prescribe policies for institutional change. On the other side, a theory of economic dynamics based on the economics of property rights comparable in precision to general equilibrium theory and capable of creating a consistent and comprehensive policy proposals concerning institutional change, doesn’t exist. New institutional economics, which stems from the initial analysis of the economics of property rights, provides only

the initial scaffolding of an analytical framework capable of increasing our understanding of the historical evolution of economies and a necessarily
crude guide to policy in the ongoing task of improving the economic performance of economies (North, 1993).

Since a full analytical framework, which would be the basis of a policy of institutional change, doesn’t exist, therefore – concludes North – a theory based on the economics of property rights can as yet only describe the characteristics of past economies, examine the performance of economies at various times and compare different institutional arrangements. In other words, as far as the evolution of economies is an issue, theory can only try to understand it, not to shape it confidently.

It is time to recall the two quotes from the beginning of this chapter. By its nature the Croatian quote is clearly prescriptive (normative). It states what should be done and what would be the consequences: When private property is established one may expect that assets would come into the most efficient hands, regardless of the institutional framework. The normative use of neoclassical economics relies on its presumed predictive power. The Slovenian quote doesn’t provide an alternative plan; it only expresses scepticism towards the neoclassical program, and its view that the establishment of market institutions (among them private property) by decree would necessarily induce the emergence of a market economy. According to the Slovenian quote there were circumstances and effects that were neglected by neoclassical economics and that should have been taken into account if the development of a market economy was to take place: inherited economic culture, people’s expectation, their confidence that the system would work etc. This illustrates the distinction between the two theories: the normative use of neoclassical economics and the descriptive character of the economics of property rights. The Slovenian quote, which emphasises the impossibility of the establishment of the market economy by decree, implies: Neither a comprehensive and consistent theory of institutional change nor an efficient political authority guarantee a successful establishment of the market economy. It requires more: people’s confidence that the system will work.

This brings us back to the role of theory in the problem of economic development. Theory matters, even if it does not generate a defined policy. Theories – the same is true of ideologies and beliefs – represent mental models that individuals and societies create to structure the disorder of the outside world and to cope with challenges and uncertainties (Denzau & North 1994). Even if they do not produce policies theories create expectations about future developments and influence the activity of participants. It will be argued that the continuous discussion
and scientific observation of the process was a characteristic of Slovenian privatisation. In my opinion, this explanation provides the answer to the second abovementioned question: how it could be that the process of privatisation in Slovenia followed the economics of property rights that was not capable of producing policy prescriptions. That is, even without the capability to create a comprehensive policy, a descriptive theory may have practical value. 

2.4.2 Unintended consequences

The first question challenged the hypothesis that institutional change in Croatia fits the neoclassical paradigm though neoclassical economics mainly analyses how a market economy works and only implicitly assumes how it emerged. Nevertheless, it is possible to create a program for the establishment of a market economy based on the neoclassical understanding how market economy works. But a policy of institutional change that relies on a neoclassical understanding might produce unintended consequences. To show that this was the case is exactly the subject of this research: namely, to test the claim of the economics of property rights, that the path of institutional changes that follows neoclassical economics might (or even must) produce failures (unintended consequences) because neoclassical economics does not understand how economies develop, rather, understanding only how a market economy works.

An example could be illuminating. I argue that privatisation in Croatia in fact took the form of an initial appropriation of assets; an unforeseen consequence of this approach was that resources were dissipated instead of leading to an increase in the efficiency of the use of resources. Contrary to the neoclassical scenario, which predicted that the allocation of resources to private individuals would initiate the development of a functioning market economy, it didn’t happen. Summing up: the policy of privatisation in Croatia was based on the neoclassical understanding of the development of a market economy, but it produced unintended consequences, because important features, which were emphasised by property rights theory, weren’t taken into account. This is the answer to the first abovementioned question: since the program of institutional changes in Croatia was based on an understanding how a market

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8 For detailed discussion about the distinction between descriptive and normative economics see Subroto Roy (1989). Also I would like to mention an excellent discussion about the implicitly normative character of “a competitive model” (i.e. general equilibrium) in first section of Kenneth J. Arrow’s famous article “Uncertainty and the Welfare Economics of Medical Care” (Arrow, 1963, pp. 941-948)
economy works and not how a market economy develops it produced unforeseen consequences.

It should be obvious that I am not engaged here in a substantial criticism of neoclassical economics. I will not discuss whether a development of the economics of property rights (and the related approach of new institutional economics), which stems from the criticism of neoclassical economics, represents a mere improvement of the neoclassical framework, or if this development forms a totally new economic paradigm. Even the strongest critics of neoclassical economics recognize that this framework may be analytically valuable. The criticism includes the view that a neoclassical framework does not capture the growth and evolution of economic systems. Using the insights that were developed within the property rights economics I describe the transformation of the property regime in Croatia and Slovenia and analyse the shortcomings of the program of privatisation that was based on neoclassical framework. I expect that a description of the processes of privatisation in Croatia and Slovenia, which forms the largest part of this work, may shed new light on the discussion between the two competing theories.

2.5 Brief summary

This research focuses on the evolution of the nature of property and on the theoretical concept of property; the accompanied political analysis mainly creates a necessary context. A systematic and comprehensive analysis of the socio-political aspect of privatisation in Croatia and Slovenia would be interesting and possibly very illuminating but it would require another investigation, another thesis. However, in the chapters that explain the processes of privatisation in both countries, I have provided some significant socio-political information about these issues; in the concluding chapters these insights are systematised. It is important to note that this systematisation is not conclusive: one should not conclude that the neoclassical paradigm backs up authoritarian regimes if the authoritarian Croatian regime used neoclassical rhetoric while distributing the

9 Lest the overall thrust of my work be misunderstood, the criticisms that I make of the neoclassical view are not necessarily a request for governmental regulation. Rather, they point to the need to take institutions, and also traditions and cultural factors, seriously, and also that the adequate functioning of a market economy itself depends on them. However, institutions might be contributed by governmental action, or by private action, or by means of an interplay between the two. The role of theory is particularly important for my research.

10 However, the analysis of the shortcomings of the general equilibrium perspective – that will be used in chapter III, as a background for the introduction of the basic concepts of the economics of property rights – could be misread as constituting a general criticism of neoclassical economics.
assets according to political criteria. This is simply not true; non-authoritarian Eastern European political regimes used neoclassical rhetoric and implemented neoclassical approaches to privatisation; many authoritarian Latin American regimes despise neoclassical economics.

The first aim of this research is to support the claim that Croatian privatisation indeed followed the neoclassical understanding and that Slovenian privatisation took place in accordance with the economics of property rights (incidentally or intentionally). How this happened, to which degree the paths were a matter of coincidence, were predetermined or were the result of the activities of economic experts and interest groups, are questions which could be answered only after it has, indeed, been established that these two different paths were followed in Croatia and Slovenia. Accordingly, the focus of investigation is on the real changes in the property regimes; and on theories of institutional change which, I will argue, are important if we are to understand the real process.

Academics, scholars and reformers in both countries relied on particular understandings of property and the market when they discussed the programs of privatisation. This is why theory matters: it creates expectations and justifies and legitimises policies. In the case of the Croatian privatisation, it is easier to find a direct influence from theory since neoclassical economics is capable of supporting policy prescriptions. The economics of property rights is not capable of producing a comprehensive policy of institutional change, but it is possible to present an indirect influence of the property rights school on the path of privatisation in Slovenia.11 The property rights approach was criticised for its incapability of producing a policy program. Property rights theory responds that neoclassical economics does not reflect how a market economy emerges; therefore a program of privatisation based on a neoclassical understanding might not produce a market economy. Since the changing of the property regime and the distinction between private and public property were seen as crucial for the transition, theoretical concepts of property should be analysed.

11 As for the (indirect) influence of property rights economics on the process in Slovenia I would like to mention that the Slovenian quote from section 1.1 of this chapter was originally published in a major collection of papers on the economics of property rights (Pejovich, ed. 2001, Vol II). Alexander Bajt, another influential Slovenian economist published in the same collection together with several Nobel Prized economists. Bajt belonged to pioneers of property rights school and already in 1992 published A Property Rights Analysis of the Transition Problems in the EAST; EIPF, Ljubljana. This paper, which presents Bajt’s proposal for the reform of socialist property regime, will be commented in the following chapters.
Chapter II and chapter III explore the same subjects (property, the problem of ownership, the origins and development of market institutions) from the positions of the two economic theories; the economic transition from socialism deals with identical problems. The ideas developed in these chapters are then utilised for the analysis of privatisation in Croatia and Slovenia. If the establishment of market institutions (among them, private property) by decree does not enable the emergence of a market economy, then the question remains: What is the substantive distinction between the old and the new property regimes? I am exploring how to understand the evolution of property regimes in Croatia and in Slovenia; why they diverge; and which theoretical concepts grasp the essence of the changes of property regimes?
Chapter II

The traditional understanding of property

The purpose of this chapter is to introduce the traditional concept of property that was assumed within the neoclassical approach to the transition to market economy. In Croatia the process of privatisation, which is a cornerstone of the transition from socialism, provoked the question whether property that was formally privatised was really private or not. A similar question, what is in fact private property, was discussed elsewhere as well: some economists considered the growth of regulatory agencies, which coordinate their activities with state officials and manage former public corporations, a more significant outcome of the process of institutional changes in the UK in the 1980s than the transfer of assets into the hands of individual shareholders (Florio 2004). From this kind of discussion the problem of the definition of privatisation appeared.

The simplest description sees privatisation as the transformation of assets controlled by the government into private property or as the transfer of government ownership (public property) into private hands. A wider concept includes “shifting of a function, either in whole or in part, from the public sector to the private sector” (Feigenbaum & Henig 1994). If defined broadly as a lessening of government involvement in economic activity, privatization covers liberalization and the deregulation of the market, and even the lowering of taxes could be considered a form of privatisation (Cass 1988). Finally, another definition - which is to some degree vague - describes privatisation as “a generic term for market oriented reforms in the public sector” (Kay 2002). It is not surprising that the term privatisation was in the end interpreted as being less analytical and having more an ideological and political significance (Starr 1988).

The disagreements in regard to the definition of privatisation reflect – in my opinion - theoretical controversies concerning the traditional concept of property. If privatisation is the transfer of public ownership into private hands, then the

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1 The most bizarre example were the Croatian corporations under the control of foreign governments but which still counted as privatised by both domestic and international analytical agencies.
question is what makes for ownership, and what is the distinction between public and private property. These are the subjects of the two beginning sections of this chapter. When, how and why property becomes somebody’s are the questions that give rise to the problem of initial appropriation, a standard issue in the theory of property. These questions are explicitly raised by John Locke; the issues that were discussed by Locke in regard to initial appropriation were also discussed during the period of transition in relation to the process of privatisation. The second section examines whether the post-socialist privatisation can be considered an initial appropriation.

This chapter investigates the characteristics of the traditional concept of property that I consider important for the post-socialist privatisation, particularly for the privatisation in Croatia, which fits – as it was claimed – the neoclassical approach to the transition from socialism. I will argue in chapters V, VI, and VII that policy programs and privatisation laws were developed under the influence of neoclassical opinion. It is important to note that even if we neglect the direct influence of theory on policy programs in Croatia, the analysis of the real process confirms that Croatian privatisation followed the neoclassical understanding of how a market economy emerged. The final section of this chapter synthesises and comments on the neoclassical view of transition that is based on the traditional concept of property.

1.1 The concept of property

According to the beginning sentence of the entry ‘Property’ in the Stanford Encyclopaedia of Philosophy, “Property is a general term for rules governing access and control of land and other material resources”. Similar definitions are used by a majority of authors about the subject. The alternative characterisation of property as “relations among persons with respect to things” (Munzer 1990, p. 17) is also to be noted. Hence, property is a twofold relationship: (1) the relationship between a person and a thing; (2) the relationship between persons. For both relations the term “right” is used. In regard to the relationship between a person and a thing Roman law systematized property as the rights to manage, use, and alienate a

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2 “A property right is an enforceable authority to undertake particular actions in a specific domain.” (Ostrom 1999, p 332)

3 Ostrom (1999) formulates a similar understanding: “Property rights define actions that individuals can take in relation to other individuals regarding some ‘thing’.”

4 The juridical distinction between right in rem and right in personam might apply here.
resource ((ius utendi, ius fruendi, ius abutendi)), while in Hohfeld’s (1964) account claim-right, privilege (liberty), power, immunity, duty, and liability describe the relationship between persons (Munzer 1990, p. 15-22; Waldron 1988, p. 62-106; both of them follow Hohfeld’s Fundamental Legal Conceptions).

The descriptions of both relationships are incomplete, and thus not definite. The Stanford Encyclopedia (entry Property) points out: “More than most policy areas dealt with by political philosophers, the discussion of property is beset with definitional difficulties.” Munzer has found examples in which it was not possible to describe the relationship between persons in regard to property by the above-mentioned legal terms without recourse to positive law. This is why lawyers usually analyse property only in a specified legal system. In my view this incompleteness of the definitions of property may be a consequence of the constant evolution of property rights.

In regard to the relationship between persons and things the ideas from Roman law have also been constantly developing. Suppose that a riverbank was assigned in common to people from villages that live along it. While standing on their land they have the right to fish and more generally to withdraw benefits from the water up to the middle of the river. Suppose that they decide to build a dam aiming to divert the water to a mill or just for easier fish catching. If they are successful, they don’t only employ the right to use the riverbank; they have acquired the right to transform the resource. It is possible that the right to transform the river in this way didn’t exist in their earlier world even in anyone’s imagination. It was created. Beside their incompleteness, the duality of property rights is to be noted for further analysis; they represent the relationship between persons in regard to things and the relationship between person and thing.

1.2 The components in the bundle

With the aim of describing property as completely as possible, five relationships of persons toward things have been emphasized (Ostrom 1999, page 339):

**Access**: The right to enter a defined physical area and enjoy nonsubtractive benefits (for example, hike, canoe, sit in the sun)

**Withdrawal**: The right to obtain resource units or products of a resource system (for example, catch fish, divert water)

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5 The interpretation of the juridical meaning of the Latin terms diverge among the authors (McCaffery 2007)
**Management**: The right to regulate internal use patterns and transform the resource by making improvements.

**Exclusion**: The right to determine who will have access rights and withdrawal rights, and how those rights may be transferred.

**Alienation**: The right to sell or lease management and exclusion rights.

All of these rights might be held by a single individual or by collectives.

It has been argued that all rights can be reduced to two: exclusion and governance (Smith 2002). While rights of exclusion are associated with private (individual) property, governance rules are related to common property. The governance rules regulate the time, quantity and other attributes of the use of a common pool resource. For example, village herdsmen may have rights to graze animals on common land according to specification of the number of animals, the time of grazing and so on.

Even this distinction between exclusion and governance has been challenged: the exclusion right might be interpreted as just another form of governance, and governance as another form of exclusion. All property rights toward a thing might be reduced to one – either to the right to exclude or the right to govern a resource (Smith 2002, p. 467). In the above example the (limited) right of a herdsman to graze animals on common land is the right of the community to exclude him from land after a stipulated period of time. Similarly, all legal relationships might be called a right, for example, privilege, power, and immunity are usually called rights (Munzer 1990, p. 31-37).

In my opinion, this kind of reduction neglects the diversity and richness of the property rights world. The right to access a national park and enjoy nature is different to the right to access it in order to fish, despite the fact that the latter case might be described as the right of a proprietor to exclude from fishing anybody without a license. This is however a problem of definition: the right of exclusion might be implemented to all attributes of a resource (i.e. a national park) at the same time, or only to specified attributes of a resource (enjoying nature, fishing and so on). Problems of definition aside, two issues that stem from this concept of property - and that are important for the investigation of privatisation - are to be discussed further. (1) What is it that makes an owner? For example, if someone has the right to exclude others from a resource but not the right to transform the resource, may we call him an owner? (2) What is the distinction between public and private property?
2.1 What makes an owner?

We have seen in the example of the riverbank that the bundle of rights might be developed, so the question is whether the earlier property right of the use of a resource makes for ownership. Is the person who has the right to exclude another person but not to transfer, transform or destroy property an owner? For a lot of people the answer is no. Then the question is what makes an owner? Paraphrasing the old sophism: adding one by one right at which stage does the bundle of rights become ownership? If it happens by adding the right to transform a resource then this is the crucial right. Munzer (1990, p. 31-37) concludes that there is no such a component in the bundle of rights that is individually necessary for ownership and that the components may only jointly be sufficient for it. However, if the bundle of rights has been constantly developing, this doesn’t solve the problem: the bundle of rights might never be completed, therefore ownership might never be definite. In the example of the construction of a dam, the right to transform a riverbed might be denied (by the community which is down the river), and it implies that the ownership of the riverside is in this case also incomplete: ownership was reduced only to the rights to fish and to use the water, but the newly created right to develop a river is not included.

An analogous question of when property was considered appropriated has been a subject of constitutional debate in the US (Stake 1999). The Fifth Amendment prohibits the government from taking property without paying compensation. However, “if the government divides rights along the dimension of use, prohibiting some uses and allowing others, it is hard to tell whether the rights taken were enough to call property” (Stake 1999, p. 34). As an example I consider an owner who holds wild and dangerous animals on a property in a residential area. Does prohibiting him from doing it imply that his property was taken from him?

Most authors agree that the powers to exclude and to transfer are the weightiest components of the bundle of property rights (Munzer 1989, Ostrom 1999, McCaffery 2007). Though it depends on the definition of ownership, it is possible to call an owner one who does not have the right to transfer a resource, but only to

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6 From the understanding that to be an owner is to have all of the rights from the bundle or most of them comes the tendency of describing ownership as follows: “[T]he right to possess the thing with a duty of everyone else to stay off, the privilege of using the thing with no right in anyone else to prevent him (coupled with a right in the possessor to prevent others from using the thing), a power to transfer any and all of his rights, privileges, and powers with a liability in anyone to be the object of that conveyance (coupled with a disability in everyone else to change and an immunity in the possessor from change of those same rights, privileges, and powers).” (Donahue 1980, p. 32)
use it. McCaffery (2007, p. 77-84) discusses the situation of a life estate ownership, which passes over to the successor on the death of the owner. Someone who inherits that estate has the right to use it, improve it; if negligent, the owner even has the right to ruin it but doesn’t have the right to transfer it freely. Nevertheless it is usually considered his own property and not anybody else’s. The restriction of the right to transfer is not unusual. It is not an exception that an artist sells his work to a museum or to an individual not allowing them to transfer it further. Such a restriction is frequent as far as intellectual property is the case. The same is true with the right of exclusion: It is possible to have the right of exclusion and not the right to use a resource, for example in the case of a national park if the use of mineral resources is forbidden.

Yet for those who reflect on property having in mind a market economy the exclusion right and transferability of property or transferability of any of the components (for example rights to use or to access a resource) are the distinctive characteristics that make for ownership. Why is exclusion so important? Investment in a resource would be futile for an owner without the power to exclude an intruder from the use of the resource. The right to exclusion enables the identification of who owns what, and it opens the possibility of trade (Rose 1994, p. 105).

Following Hegel, Munzer (1989) argues that the right to exclude (an intruder from property) doesn’t exist without the materiality of property (Hegel 2001; section Property, paragraphs 49-53, p. 60-63). According to Hegel, to be an owner implies having intentions toward property and the possibility of causing physical changes in the property. Munzer concludes that copyrights and patents traditionally require some writing or drawing or a model through which rights are claimed. “Intangible property” cannot be effectively protected without a material equivalent. Bank accounts and corporate shares are - for some authors (Grey 1980) - examples of intangible property but, at the end of the day, they always presuppose the demand for some material resource. As for an artificial person “corporate owners ultimately must be owned by entities capable of having intentions”(Munzer 1989, p. 71), that is, by individuals.7

7 Thomas Grey (1980, p. 69-85) notes that in ordinary life property is conceived as “things that are owned by persons. To own property is to have exclusive control of something – to be able to use it as one wishes, to sell it, give it away, leave it idle or destroy it.” (Emphasis in the original.) Grey finds a striking similarity between this concept and the understanding of ownership that originates from the 18th Century. He quotes Blackstone’s description of property as “that sole and despotic dominion which one man claims and exercises over things of the world, in total exclusion of the right of any other individual in the universe”. This is, according to Grey, the concept of ownership in the French Civil Code, in Locke, Kant and Hegel.
From the understanding that the right to alienate property includes the power to transfer it freely as a gift, or to abandon it - in other words to waste property and to destroy it - follows the conclusion that this right constitutes the absolute ownership of property (McCaffery 2007). The right to destroy property normally assumes the liberty to transform and improve a resource (and vice versa) and this is one of the examples that illustrate how all the components of property rights are interdependent. In my understanding, Locke’s justification of private property relied on the conviction that private property enables the improvement of resources (makes for the productive use of resources), prevents the waste of resources and minimizes the risk of the destruction of resources. The economics of property rights is concerned with the same problem; it analyses the economic effects of different arrangements of property rights.

Privatisation was understood as the transfer of state ownership into private hands. In the case of companies in Croatia and Slovenia, before the transition they were managed and used collectively by employees and the community. However, the rights to manage and use resources weren’t transferable. The idea of the transformation of this property regime was to develop a property right that improves the use of a resource but doesn’t at the same time open an additional possibility that the resource might be destroyed. Transferability of property was seen as the solution. As for the question which right was to be transferable and under what conditions, the Croatian answer was the transferability of a unified bundle of property rights that was identified with ownership. It was assumed (without particular analysis) that this reform would enable an improvement in the use of resources regardless of the attributes of the resource. The distinction between public and private property is still to be explained.

2.2 Private vs. public

A clear and specifically defined distinction of the difference between public and private property might be impossible to achieve. If this is the case, there is a problem for the definition of privatisation as the transfer of public ownership into private. It will be suggested in chapter V that the discussion whether self-management represents a form of public ownership or if it was already a form of private property, since it was not considered state-ownership, decisively affected the design of privatisation in Croatia. Public ownership may be defined as property held or controlled by a public body, but in the absence of any other distinction the question remains what is changed if that property is transferred to a private
person? If there are no other distinctions, what is the purpose of privatisation; why privatise? In the distinction between public and private property there must be something essential that justifies the transfer of assets controlled by a public body into private hands.

I will here briefly comment on few common methods of distinguishing between private and public property. These methods – in my opinion – are not theoretically well grounded and the process of transformation of public property into private (privatisation) that relies on these distinctions encounters difficulties. It will be presented in chapter V that the discussion whether self-management represents a form of public ownership or if it was already a form of private property, since it was not considered state-ownership, decisively affected the design of privatisation in Croatia. In my opinion, for the understanding of the process of changes of the property regime in Croatia and Slovenia more appropriate than the simple distinction between private and public ownership is the distinction between open-access, then individual and collective property. This distinction, which is theoretically more convincing, will be further examined in chapter III from the position of property rights economics. Hereafter I will briefly present how Munzer, Rose, Ostrom, Demsetz and Alchian commented on the distinction between public and private property.

Munzer distinguishes between private and public property in the following way:

If the owners are identifiable entities distinguishable from some larger group, there is private property. The most common example is individual private property, where an individual person is the owner – in severalty, as lawyers say. Other sorts of private property exist when the owners or right-holders are persons considered, such as partnerships and cotenancies, or are artificial entities that represent the financial interest of persons, such as corporations. Contrasted with private property are various sorts of public property. Here the owners are the state, city, community, or tribe (Munzer 1989, p. 25, emphasis in the original).\(^8\)

This distinction doesn’t seem precise enough. Residents of a particular city are distinguishable from a larger group, for instance from residents of a region or from a nation; nevertheless their ownership Munzer considers a public ownership rather

\(^8\) Later chapters in Munzer’s book distinguish private and public property from the utilitarian and moral perspective which is not helpful for our purpose.
than private ownership. Some other criterion must be involved to explain why shareholders own a corporation privately, while members of a tribe or community own public property. Rose notes that public property so understood “still has a single owner and speaks with a single voice; this corporate body can manage, buy, and sell its property just as any other owner does”. Therefore, Rose concludes: “[I]f we think of the public not as an unorganized assemblage of individuals but rather as a corporately organized governmental body; such ‘public’ ownership is only a variant on private ownership” (Rose 1994, p. 109).

However, the criterion can be: the property of a public body (state, city, tribe) is public property, while all other properties are privately owned. Though this is the most common criterion, it doesn’t follow from the nature of ownership, from the relationship between an artificial person and a thing but from the characteristics of an owner. It seems that Demsetz (1967) used this criterion to distinguish between communal ownership, private ownership and state ownership:

By communal ownership, I shall mean a right which can be exercised by all members of the community. Frequently the rights to till and to hunt the land have been communally owned. Communal ownership means that the community denies to the state or to individual citizens the right to interfere with any person’s exercise of communally-owned rights. Private ownership implies that community recognises the right of the owner to exclude others from exercising the owner’s private rights. State ownership implies that the state may exclude anyone from the use of a right as long as the state follows accepted political procedures for determining who may not use state-owned property (Demsetz 1967, p. 353).

A substantial distinction between “communal ownership”, “private ownership” and “state ownership” is not easy to see here. Both the private owner and the state “exclude” others who try to interfere in their rights, while the community “denies” interference in communal rights. These three types of owner exercise the same right of exclusion of an intruder from the use of their property. Demsetz compares individual and communal ownership and concludes that a private owner is motivated to improve his property while communal ownership is exposed to overuse. The same could be concluded for every type of collective ownership, for example for a corporation in the ownership of dispersed shareholders, who often act as free riders: they expect that other shareholders take care on the use of resources and prevent the destructive management of resources. (Vickers &
Yarrow 1988). Demsetz’s communal ownership, though owned by a ‘public body’ is - in Munzer’s understanding - private property since it is – in Demsetz’s words – protected from the state’s interference.

One may say that private property is distinct from public property since the position of the state in relation to the market is different from the position of an individual. The owner of a state-owned corporation regulates the regime for the use of its own resource and for the use of the resources under the ownership of an individual who is not so powerful: for example, the state taxes both corporations in its ownership and corporations in the ownership of others. This is a strong argument, though corporations owned by a government often compete on a market without privilege. Attributes of an owner affect the character of property rights. It is not the relationship between an owner (the government) and the thing that defines what is private property; if the state behaves as a private owner the distinction between private and public property disappears. All these arguments are strong as well but not decisive.

2.2.1 Terminology

Terminology in the area of property rights is not harmonised and this might be the explanation for this misunderstanding what people understand as private or public property. Ostrom (1999, p. 335), for example, notes the confusion between common property and open-access. Demsetz - while explaining that communal ownership is exposed to overuse – in fact equalises open-access and communal ownership. On the other hand, Rose concludes that open-access and public property could be identical; if so understood “‘public property’ is an oxymoron: things left open to the public are not property at all but rather its antithesis” (Rose 1994, p. 101). However, an adequate procedure sometimes protects communal ownership from overuse. In this case it is a form of collectively owned property (common property).9

To me, the distinction between individual (private), collective and public property, which may be understood as an open-access, seems promising. Unowned property is the subject of the following section about initial appropriation. The issue here is the distinction between individual property and collective property, regardless of whether the collective property was owned by the state or by some narrower collective.

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9 In Croatia the forests owned by the state are much better protected from overuse than those owned privately. Successful communal ownership is recorded around the world (Ostrom et al 1999)
Following Alchian (1997), the conditions for property to be private include (1) non-shared decisions, (2) the effect of a decision falls on the decision maker, (3) transferability of property rights and (4) control of a resource and not just the income stream from a resource. These criteria are important for the understanding of property. However, criteria (3) and (4) don’t in fact distinguish individual and collective ownership. Criterion (2) is open to discussion. The effect of the decision of a particular collective body in any case falls on the members of that body, though a proportional distribution of costs and benefits is not a necessary rule. Some members may be privileged in such a way as to avoid negative effects. I will explain in chapter III how the economics of property rights uses this non-proportionality criterion to distinguish between collective and individual property.\(^\text{10}\) Hence, the key criterion is Alchian’s non-sharing decisions. Following this criterion, both a shareholding corporation and a public corporation (the one owned by a state) belong to a collective and not individual ownership, though a procedure of voting to reach a decision is usually different. In both cases, the decisions are shared among those who vote. However, this classification neglects the distinction between a public corporation and a private corporation. Demsetz’s and Munzer’s criteria might be useful again, but not as sole criteria any more. The problem is essentially whether rules of market exchange favour the public corporation over the private one; though the rules might favour one private corporation over another one. It is a problem of the regulation of market. As I mentioned earlier it might be impossible to define clearly the distinction between private and public property, which is really complex and exposes to unbridgeable difficulties those who want to transform socialist property into a regime that is dominated by private property.

### 2.2.2 Resources and the regime of their use

The next confusion noted by Ostrom (1999) is between a common pool resource (which might be a company or common grazing area) and a common property regime. Here, the duality of property rights comes into sight: a common pool resource is a thing, while a common property regime is an example of the relationship between persons in regard to things. As for a common pool resource, one person’s consumption subtracts from the quantity available to others; it is a variant of collective ownership in which the exclusion of a beneficiary might be prohibitively costly. I would like to remind the reader that not all variants of collective ownership are exposed to

\(^{10}\) The teamwork in a company is an example of collective use of resources; in the case of teamwork it is impossible to distribute rewards according to inputs.
overuse (Ostrom et al 1999); if this is the case, the fact that socialist property was a form of collective ownership wasn’t a necessary reason for its overuse.

A common property regime is to be explained in regard to the distinction between public and private property. The property regime regulates the use of resources, regardless of whether they are in individual or collective use. Rose emphasises that "a private property regime holds together only on the basis of common beliefs and understandings" (Rose 1994, p. 5). They in fact embody a common property regime. It is a common belief that the restriction of having wild animals on a property in a residential area doesn’t imply the taking away of property, though the community in this case restrict to some degree private ownership. Those who advocate private property count on some common understandings as well; behind insisting that private property is more efficient than collective property lies the assumption that a more efficient regime is a priority. If private property in the form of self-management (if self-management is considered private property) is not sufficiently efficient it may be replaced by an alternate regime, for instance by majority ownership of the firm. In this case the privatisation of socialist property wasn’t a transfer of public property into private hands but it was a transformation of property regime: one property regime which was based on private property was transformed into another one, which was based also on private property, but of another kind.

Ostrom (1999, p. 334) agrees with Rose that the private use of resources is regulated by a kind of ‘commons’: common beliefs impose restrictions on the private use of property. Transformed into law, common beliefs and understandings may become the rules that - for instance - regulate the financial system; *a common property regime* regulates the use and transfer of private property. It implies the existence of a right that belongs to a community (society), which is superior to the individual right of use of resource. Looking from a broader perspective, common beliefs that regulate private property represent a collective ownership of a wider common pool (nature, for example, or a total national wealth) that is divided in individual property.

It seems that the distinction between public and private property might not be taken for granted and as unproblematic; the question of which component of a property rights bundle makes someone an owner may also not be clear. Then the questions are: what was privatisation and what was the process of transition from socialism? Since resources in Slovenia and Croatia before the transformation of the property regime were managed and used collectively, while individuals enjoyed
particular property rights, the question of privatisation was: which further rights were to be transferred to individuals and which regime was to regulate individual rights? Under socialism, income from a common pool was allocated to certain individuals; they also had the right to use a certain resource. What right was to be transferred from a common pool to make an individual an owner and transform socialism into capitalism? Chapter V, which describes the debate about the transformation of self-management and social ownership, and further chapters (V to VIII) that describe the real process, show how important for the process of privatisation different conceptions (understandings) of private, collective and public property were.

The distinction between *common pool* and *common regime* relates to the old discussion of whether private property emerged by allocation of particular rights over a common pool resource to individuals and what was left was under common (public) rule; or if collective property was formed by individuals giving up their natural rights. Hobbes and Bentham advocated that private property is a creation of the sovereign state, so they might be considered advocates of the former view. Since a number of authors emphasised that a socialist state before privatisation was in a position to abandon its ownership for another’s benefit (Bicanic & Skreb 1992), the privatisation of socialist property might be understood as an echo of Hobbes’s and Bentham’s scenario. For Locke, private property was an individual natural right, which belongs to an individual regardless of the community; though the principles on which the Lockean right to property rely could be understood as a common regime, a system of common beliefs, and understandings, which enables a creation of private property.  

I claim that privatisation in Croatia shares particular characteristics with a Lockean initial appropriation. The principles of the emergence of private property in Locke will be presented in the next section.

### 3.1 Privatisation and initial appropriation

The purpose of this section is to show that privatisation of socialist property may be interpreted as the creation of a property regime *de novo*, that is as initial

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11 I don’t want to go here deeper into the discussion of whether all property rights were allocated and allowed by the sovereign as was explained by Hobbes (and Bentham) or they were to be understood in terms of natural right, God given, before existence of any government, as in Locke. For further discussion of this subject see Horne (1990). Closest to my understanding is Hegel’s explanation that property rights (both collective and individual) are a creation of free subjects on the path of self-articulation (the subject’s returning to himself). However in Hegel’s explanation not only property rights but also the state is a stage on this path. I think that Hegel’s understanding enables a productive discussion about the problem of the evolution or creation of property rights de novo.
appropriation (akin to the kind of thing familiar from John Locke). In order to do this I will firstly try to explain, in the simplest way, the characteristics of Lockean appropriation. Secondly, I will briefly describe how these issues re-appeared in the context of the privatisation of socialist property. Thirdly, I will derive the important characteristic that confirms or refutes the claim that a particular privatisation of socialist property is appropriately described as initial appropriation. Obviously, I don’t want to involve myself in complex issues concerning the interpretation of Locke, or to suggest any necessary parallelism between the historical background of Lockean theory and the transition from socialism. I have simply found it fruitful to look at the process of privatisation bearing in mind the dilemmas that were discussed by Locke.

3.2 Lockean principles of appropriation

By definition, a property regime can be created de novo only over non-appropriated (res nulius) or abandoned (res derilectae) assets. It was assessed in Croatia (and to some degree in other countries created after the dissolution of the former Yugoslavia) that the assets to be privatised were so badly managed and neglected that companies’ assets were nobody’s property – as nobody was responsible for taking care of them. The demand that a property regime must be imposed over neglected (wasted) assets brings to mind the spoilation proviso known from Locke’s discussion on property. In addition to the requirement that (1) a resource must not be spoiled but improved, during the transition from socialism there were strange echoes of two more Lockean principles of appropriation, which will be discussed in the following sections of this chapter: (2) labour was considered a basis for appropriation, and (2) enough and as good must be left for others (the sufficiency proviso). Particularly important is (4) the relationship between private property and the market that was also discussed by Locke. The principles of initial appropriation are components of a common property regime as was indicated above. However, it is not possible to capture here all aspects of these principles, which has widely been discussed in the literature on Locke and on property. Since they are universal principles that are reflected in almost every discussion about

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12 The importance of no-ownership rhetoric for the development of the process of privatisation in Croatia I will discuss in the following chapters.

13 It is possible to distinguish in Locke wasted assets (which weren’t yet appropriated) and assets which were for some reason neglected by a private owner or spoiled. This later assets might be returned under common ownership. But for now this distinction is not crucial.
property, I will describe them only briefly to show that a variant of them was
discussed in Croatia as well.

For an easier understanding of Locke, Waldron’s (1990, p. 222) systematisation
might be helpful: “If we want to periodize Locke’s theory of property, we should talk
perhaps of three phases: (1) rough equality under conditions of plenty; (2) unequal
possessions, under conditions of scarcity, made legitimate by the introduction of
money; and (3) the regulation of property under government. Perhaps (2) leads
eventually to (3), on Locke’s account, but it is mistake nevertheless to identify
them.” An obvious distinction between Croatian privatisation and the scenario
discussed by John Locke is that the transition from socialism was not from a state
of nature. The Lockean state of nature is complex. At the beginning it was an
undeveloped world with a plenitude of uncultivated land (Locke would say it was
wasted land). If it were only a world of plenitude, there wouldn’t be a need to set
up any right other than the right to consume. In this circumstance one person’s
appropriation wouldn’t really matter to anyone else, therefore the rights to
exclusion and to transfer would be senseless (Rose 1987). However, the question
is, does the right to consume constitute ownership at all? On the other hand, the
world of plenitude of his time (America) Locke described as a poor world since “a
king of a large and fruitful territory there feeds, lodges, and is clad worse than
a day labourer in England” (Locke, Second Treatise, chapter V, paragraph 41, p.
135).

3.2.1 Labour and the spoliation proviso

Though it begins in this undeveloped world, an initial appropriation could
hardly be conceptualised without any criteria and procedures. What serves
such a role may be customary principles like first come-first served and
finders-keepers. If something is somebody’s on the basis of force, it is open
to be attacked in the circumstances of a changed balance of power. In regard
to initial appropriation an imagined third party is always present. A third
party might decide, following customs or a particular way of reasoning, that a
carcass belongs not to the hunter who spent the longest time in hunting and
put the most effort in it but to the hunter that killed the animal (Bouckaert,
1999). In this case a third party introduces the criteria or formalises customary
principles of appropriation. A radical alternative to this rule is a battle over
un-owned property.
It is interesting to note that Locke implicitly prefers the hunter who puts the most effort into chasing the animal over the one who actually killed it: “[T]he hare that anyone is hunting is thought his who pursues her during the chase. For being a beast that is still looked upon as common, and no man’s private possession, whoever has employed so much labour about any of that kind as to find and pursue her has thereby removed her from the state of Nature wherein she was common, and hath begun a property” (Locke, Second Treatise, chapter V, paragraph 29). Waldron (1988, p.173) calls it the Labour Theory of Appropriation. In Locke’s view the resource that was appropriated must not be spoiled (wasted). Since assets usually deteriorate by themselves the acquirer must improve them, and labour might do this. Locke expected that an owner would do it by himself, and this is his strongest argument for private property. At the same time the dictum that property must not be wasted implies that the right to property is not absolute but limited in Hohfeldian terms to a liberty and a privilege to use the resource under particular conditions.

To some degree Locke is not consistent, or at least not clear enough. Property might be returned to common ownership only if it was not used, if it was abandoned or neglected, left to deterioration. Waldron notes that Locke understands the term “to use property” generously: it is up to an owner to decide whether the thing is left to an negligent destruction, so it might be returned to common ownership, or it is used purposefully. In Locke’s account man is given the right “to destroy any thing by using it” (Locke, First Treatise, chapter IV, paragraph 39, p. 29). Given that property cannot be taken from an owner without his consent it implies that Locke didn’t imagine that an owner might purposelessly destroy property (Waldron 1988, p. 219).

3.2.2 The sufficiency proviso

Locke recognised the possibility of over-appropriation of goods, for example fruits that could be spoiled. The relationship between private property and the market is to be emphasised here. Locke expected that money and market exchange were mechanisms that would resolve controversy: ownership was to be absolute and at the same time property should not deteriorate. As it is improved, a resource creates a surplus that might be exchanged for goods that might last longer (walnuts) and wouldn’t be wasted. In Locke’s account money is a method of saving value through exchange and through transformation of deteriorating products to long-lasting goods. Money serves to offer a way round the spoilage proviso. In the context of
my research it is important to note that initial appropriation precedes market exchange but the market also (and money) enables an efficient use of privatised and improved property.14

The most complex constraint on initial appropriation is the Lockean qualification that the acquirer should leave “enough and as good” for others (Locke, Second Treatise, Chapter V, paragraph 33). The proviso doesn’t seem sensible in the world of plenty, while it is hardly possible to fulfil it if resources are limited. Nozick (1974, p. 181) analyses the possible application of the proviso to a number of examples and concludes that the “Lockean proviso is not an ‘end-state principle’”, i.e. the principle does not rule “who ends up with what”; “it focuses on a particular way that appropriative actions affect others, and not on the structure of the situation that results.” More directly, Nozick asks whether an appropriation worsens the conditions of others. Since Lockean appropriation follows from the state of nature, it was not reasonable that appropriation worsens anybody’s condition but only enriches at least somebody if not all. A similar belief legitimises the post-socialist privatisation.15 Nevertheless, it looks as if those who requested mass privatisation by way of an equal distribution of shares interpreted the sufficiency proviso in such a way that nobody should have been excluded from getting a piece of the cake.

3.3 Lockean principles and privatisation

Privatisation in socialist countries encountered issues familiar from the Lockean discussion. Workers claimed that the assets to be privatised belonged to them because “they created them” or they integrated their labour with them. This understanding was a basis of justification of the method of privatisation that relies on insiders (employees and managers).16 However, the assets weren’t created \textit{ex nihilo}, but from available material that belonged to somebody. The pre-socialist owners whose property was nationalised and given over to workers’ management requested re-privatisation. In some cases the government or the

14 Buchanan, following Hobbes, also insists that initial appropriation takes place before a market, which is in his analysis an expression of mutual recognition of property rights. (Buchanan ... Chapter 2) James M. Buchanan: The Limits of Liberty: Between Anarchy and Leviathan, Chapter 2; available at http://www.econlib.org/LIBRARY/Buchanan/buchCv7Contents.html

15 However, I do not claim that Nozick’s interpretation is ultimate; I only explain how Lockean proviso reappears in the process of privatisation.

16 Of this kind was the method of privatisation in former Yugoslavia before its disintegration. It will be seen that the other Lockean concerns in regard to appropriation have found their way in a method of privatisation.
community provided the initial investment. If assets before workers’ engagement really didn’t belong to anybody then they should have been the subjects of an initial appropriation. It might then have been the case that other people could have also mixed their labour and creative power in it if the original material had been allocated to them before the workers who claim their ownership grabbed it and transformed it. These other people were deprived of the possibility to employ their productive power and mix their labour; they could thus argue that they should deserve a new chance especially if a new distribution takes place. This was the argument of citizens in socialist countries who weren’t employed or who were employed in loss-making companies against the proposal that companies should be transferred to the workers. They requested their part of the cake and often part of the assets was disposed of to citizens under favourable conditions. Finally, the excessive rights of employees, together with bad management conducted by public bodies, were blamed for the deterioration of resources under socialism. Why should the remaining assets then belong to them? This clearly relates to the critique of the general principle of desert as the basis of right to property: if labour is mixed in property why does a labourer deserve to be compensated by ownership and not somehow differently; if industriousness should be awarded by ownership why shouldn’t honesty (Waldron 1988, p. 201-207). It is not easy, if possible at all, to find a moral justification of ownership.

3.4 The distinctive feature of initial appropriation

The above similarity between the Lockean discussion of property and the controversies that emerged during the transition doesn’t show that the post-socialist privatisation took the form of an initial appropriation. Any reallocation of property, not only initial appropriation, might be regulated so that the sufficiency proviso or the spoliation proviso were taken into account. The obvious distinction to the Lockean initial appropriation is, however, that the transition from socialism was not something that took place within a Lockean state of nature. The fact that socially owned assets were considered nobody’s property is not enough to identify the process of privatisation with initial appropriation. In some countries valuable assets (treasures), which are found and don’t have legal claimants, don’t belong to the finder but must be put on auction. Governments organise auctions or distributions of new types of or newly discovered scarce resources: e.g. frequencies of the broadcast spectrum or subsurface minerals (Bouckaert 1999). These cases

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17 Nozick (1974, p. 174), analyses in detail controversies about the Lockean principle of mixing labour into property as a justification of ownership.
could hardly be called an initial appropriation (except by the government, but it doesn’t change the point).

### 3.4.1 Initial allocation and initial appropriation

It may be helpful to distinguish between an initial allocation and initial appropriation. The above examples when governments organise an auction of nobody’s property might be named an initial allocation. The engagement of the government (a third party) in the process of acquisition of un-owned assets, following a transparent law, might be understood as a refinement and empowerment of norms that govern initial assignment.

In contrast to initial allocation, initial appropriation (first occupancy) involves the idea that one agent by his sole action of acquisition of a resource imposes a duty upon others (to refrain from using “my” thing) without their prior explicit consent (Waldron 1988, chapter 7). “Mine” is senseless if it doesn’t imply “not yours”. Others may assess this acquisition as just, whether intuitively or relying on particular reasoning. We intuitively accept that a parking place belongs to the one who first occupied it. If an individual acquisition of a resource makes others better off, this acquisition may also be accepted as reasonable or even just. Economic arguments were the strongest in socialist privatisation that was aimed to increase the efficiency of the use of resources. The spoilation proviso and the sufficiency proviso are also a form of justification of initial appropriation; they are preconditions under which initial privatisation might be justified. However, it is also possible for initial appropriation to be unjustifiable. The discussion of whether privatisation was reasonable, just and economically efficient has been continuing in Croatia.

Privatisation in Eastern Europe was usually organized as the selling of state owned assets or as the distribution of shares. Neither of these two methods resembles an initial appropriation, since both methods include a kind of prior consent, before the allocation of assets. Initial appropriation takes place before market exchange. I will demonstrate in the following chapters that the process of privatisation in Croatia took the form of initial appropriation. The concentration of ownership after the initial allocation of shares occurred without an organized, transparent and fair market, that is, without the implicit consent of those who were affected. This was the real process of initial appropriation. There was the possibility that later assessment could justify it as reasonable and even just. Some criteria to assess initial appropriation as such were discussed by Locke.
and these criteria reappeared in the discussion about privatisation in Croatia and other countries.

As far as the concentration of ownership is the case it is to be noted that at the beginning of the transition the thesis was advanced that the process of privatisation may slow down the development of the market. Alexander Bajt, a Slovenian economist, already in 1992 concluded that both privatisation and nationalisation emphasise the control of resources instead of marketization (Bajt 1992). Holding the rights to control and management in the hands of one person suppresses the development of the market for labour and the market for management skills, which Bajt refers to as intangible property. Chances for the development of entrepreneurship and an increase of the efficiency of the use of resources are missed (Bajt 1992). From analysis of the process of privatisation in Croatia it turns out that privatisation did not significantly stimulate the development of the market; the old socialist structure was regenerated in a new “privatised” form; it seems that this happened exactly because of the emphasis on control of property in the form of the concentration of ownership in contrast to the creation of conditions that would enable the decomposition of the bundle of property rights and development of the market.

It is the traditional concept of property that assumes clear and indubitable ownership as a precondition for market exchange. This was uncritically transferred into the idea that privatisation should produce a clear and indubitable control over a company in the form of majority ownership. Bajt warned that the emphasis on control of a company might prevent the marketization of intangible property and the transferability of the rights to use various attributes of resources.

4.1 The neo-classical view of transition

At the beginning of this section an outline of the neoclassical scenario of the transition from socialism that includes the traditional concept of property is briefly presented. Then follows a critique of neoclassical economics in general terms, from the position of the economics of property rights. Finally, I explain the property rights view of initial appropriation, which was implicitly allowed within the neoclassical view of both the genesis of a capitalist economy and of the transition from socialism in some countries. It was already indicated in chapter I
that Croatia followed the neoclassical path of transition. To establish this claim it is much more important to identify “neoclassical phases” in the transition from socialism in the real process in Croatia than to show the influence of neoclassical theory in the policy of transition in Croatia. Nevertheless, I will show in chapters V-VII that the neoclassical understanding of how a market economy emerges and works was predominant among Croatian policy makers and Croatian economists. A striking example is *The Conception and the Strategy of Economic Development of the Republic of Croatia* (CSEDRC 1992), a collective endeavour of Croatian economists which was published in April 1992. The leading author and editor of this *Conception* was Borislav Skegro, who later became vice prime minister for the economy. In 2005 Skegro explained that *the Conception* was the informal program of the Government.

### 4.2 The Nirvana scenario

The neoclassical approach to the transition from socialism expected that the transfer of public ownership into private hands would trigger a chain of events that would eventually lead to the westernisation of socialist societies and economic growth. The scenario assumed a few basic steps: privatisation initiates and intensifies the exchange of goods and competition; the market was to be deregulated; institutional preconditions were to be reduced to the protection of private property and of contract; the public and private sphere were to be sharply separated; unrestricted market exchange places resources in their most efficient uses - and economic growth follows. It was even assumed that decentralised control over assets enables the protection of basic political rights and encourages the growth of liberal democracy.  

The scenario was drafted on the basis of a particular interpretation of the evolution of western societies and on the basis of the image that Western societies saw of themselves when they looked in the mirror of communist countries. The transition from socialism was to confirm that this mechanism works. The transition economies were understood as a “particularly good laboratory for understanding the dynamics of market evolution” (Estrin 2001). The above scenario was named the Nirvana scenario of the transition (Colombatto & Macey 1997). However, it represents an oversimplification

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*The Conception* will be commented on in chapter V: The Privatisation Debate  

The reformers of socialism inherited this last idea from its passionate defendant and promoter Milton Friedman (1962): *Capitalism and Freedom*  

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of neo-classical economics but this oversimplification was widespread and was even expressed in the formal recommendations of international financial institutions.

Ten years after the beginning of the process it was concluded that some countries in transition had failed, that they had produced something other than the ideal picture of a flexible market economy and political freedom. The Nirvana scenario was not capable of explaining the variations among the countries in transition; why some countries succeeded and others did not, especially when they had the same proportion of privatized assets. However, it doesn’t mean that the experience of transition from socialism by the unsuccessful countries was not without some value. It might be that the experiment in exactly these countries sheds new light on the mechanism of the development of both capitalism and freedom.

4.3 A critique of the neoclassical scenario

Here I will provide a brief and mostly general critique of the Nirvana scenario from the position of the economics of property rights. A comprehensive analysis of the transition requires the introduction of basic principles and concepts of the economics of property rights, which will be provided in the next chapter.

In the interpretation of property rights economics, classical Walrasian economics failed to analyse central economic institutions like property, the firm and entrepreneurship; it ignored varieties and real distinctions between different kinds of property regimes. “In the Walrasian model, where prices are sufficient for efficient allocation, institutions are superfluous; firms, clubs, tribes, or families cannot enhance efficiency” (Barzel 1989, p. 9). This comment coincides with Bajt’s above conclusion that the priority of the reform of socialist companies, in order to increase their efficiency, should have not been privatisation in the form of the

20 The following quote illustrates the typical understanding of the relationship between private property and unfettered market: “[P]rivate property gives property owners the rewards of their labour on what is ‘theirs’, and thus a property regime encourages them to take care of their property – to invest their time, effort, and talents on it – or to sell the property to someone who can make even better use of it. When all this investment and buying and selling reaches equilibrium… the end result of a private property system is … the biggest possible pie.” (Rose 1987)

21 Here I refer to the Washington Consensus, a set of prescriptions for the emerging economies in crisis promoted by the IMF and the World Bank. The term Washington Consensus was created in 1989 by John Williamson, at that time an adviser to the IMF, and originally refers to the reforms in Latin American countries. The set includes fiscal discipline, tax reform, trade liberalisation, a competitive exchange rate, and privatisation… (Williamson 2002). The reformers of socialist countries accepted the Washington Consensus giving special attention to privatisation.
concentration of ownership but liberalisation of the market. The Walrasian model
is not concerned with the problem of what is responsible for the fact that the
ownership of one company is dispersed among a number of shareholders while in
another it is concentrated. Hence the question is whether the Walrasian model is
appropriate to understand the transition from socialism?

It was already indicated (section 2.2) that the public-private distinction in some
cases might be arbitrary. Ronald Cass concludes that “the difference between
public and private enterprise is not absolute” (Cass 1988, p. 482). The distinction
might be reduced to the conclusion that in the hundred percent public property
world there was no competition, and production and consumption (supply and
demand) are centrally organized. In a competitive environment private firms
“pursue a single, clear, joint goal: profit maximisation. Public enterprises, in
contrast, seldom possess a single or a clear goal” (Cass 1988, p. 483). Such
reasoning implies that transfer of ownership from a public body to a private one
is not the only path of reform and increase of efficiency of a public corporation.22
When such public property is transformed into private property the issue is
what is actually transferred into the private sphere. Before privatisation these
corporations were very often forbidden to stop producing loss-making goods and
from replacing them by the production of profitable ones. They were also limited
in the pricing of goods and services and were obliged to allocate services where
they weren’t justifiable economically. After privatisation a new owner might (or
might not) manage a resource freely, might transform it and even might close
the corporation or sell it again. Property rights economics puts emphasis on an
institutional environment that creates incentives and restrains the effects of
economic activity. The institutional characteristics of a market decisively shape
property rights. It has been concluded that privatisation without an increase in
competition (and without the exposure of a new owner to risk) didn’t enhance
the efficiency of privatised companies in Eastern Europe (Birdsall & Nellis 2005).

4.4 Privatisation and initial appropriation

In Croatia, shares of companies were initially allocated to workers, management,
citizens and financial organizations. Development didn’t follow the further steps
that were assumed would then occur by the above neo-classical scenario. I argue

22 The proposal that instead of privatisation the orientation of the management of a public
corporation towards profit maximisation would be a priority of reform will be discussed in chapter
V.
that in Croatia the process of concentration of ownership took the form of an initial appropriation. Here I will briefly criticise initial appropriation from the perspective of the economics of property rights. A complete picture will be clearer only after a detailed description of the process of privatisation in Croatia (chapters VI, VII). I would like to recall that initial appropriation by definition occurs without a relationship to any prior property regime; consequently it occurs before market exchange; in the neoclassical framework it is a precondition for market exchange.

The economics of property rights identifies several causes of the dissipation of resources in the situation of initial appropriation (Lueck 1995):

(1) Control over a resource may be established too early (a rush for establishing control); since the only reason for appropriation is to take control over a resource then it occurs at the moment when the marginal costs of doing so are higher than the marginal return of a resource;

(2) Due to the obscure method of appropriation and lack of clarity of possession\(^{23}\), costly litigation over the control of a resource may be frequent;

(3) Sole ownership over a resource, when established, missed the opportunity of possibly more efficient cooperative uses of resources; depending on the attributes of assets and on the characteristics of a market an alternative ownership structure may emerge, for instance partnership, dispersed shareholding, franchising and the classical capitalist firm.

I would like to say that all three effects of the rush for taking control over resources were to be found in Croatia. After an initial allocation of shares it takes time to develop a transparent market that allocates securities to the place of their efficient use. An initial appropriation occurred, the property rights analysis concludes, because: contracting between shareholders is costly while an efficient market was not yet being developed; the estimation of the value of shares is uncertain; transactions between the holders of financial claims and other input owners (labour, skilled subcontractors and so on) are too expensive to provide a return which is adequate to former investment and to expected future value. Resources - i.e. companies that were not any more under public control - were exposed to

\(^{23}\) Initial appropriation occurs without the prior consent of those who would be affected; it is also important to note that later justification may fail. If ownership is appropriated under "obscure conditions" and people conclude that the new regime could not be justified, it may happen that new owners make an effort to prevent the development of the rule of law (Hoff & Stiglitz 2004)
waste; the initiative to improve resources was weak. The economics of property rights recognises that under circumstances of dispersed ownership and without formal or informal regulatory support maintaining control over a resource (e.g. a company) is very expensive and the use of resources is not efficient.\textsuperscript{24}

In Croatia, after the initial allocation of assets those who aimed to take control over resources tended to avoid the financial market (specifically it was a market for securities), due to the costs of making use of this market mechanism. A rush for control over companies through non-market exchange occurred. The owners of larger stakes of shares - i.e. banks, pension funds, some insiders in companies and the individuals who had the privilege to get loans to buy shares under non-transparent circumstances - exchanged blocks of shares without pricing in order to take control of particular companies.

The question is: How it was possible that Locke supposed that initial appropriation was a method for the improvement of resources, while in Croatia it led to the waste of resources? Beside the distinction of circumstances and other explanations, I would like to note the difference between the attributes of assets that were appropriated. In the Lockean case, as well as in the cases of initial appropriation in Australia, New Zealand and America it was land and unified ownership that didn’t require further regulation than elementary protection of assets. The chapters about privatisation in Croatia and Slovenia will serve to identify methods and circumstances of the use of very different resources and possible causes of the dissipation of resources. The rising transaction costs under unregulated circumstances and the related waste of resources were the causes of the economic crises in the countries in transition (Collombatto & Macey 2001).

\textbf{5.1 Basic position}\textsuperscript{25}

It is to be noted that the basic position of the two doctrines (neoclassical and the economics of property rights) is in fact the same (though the authors from

\textsuperscript{24} According to Lueck (1995), in order to prevent the dissipation of resources, the transferability of ownership over a flow of income (shares represent the right to a percentage of income) is to be regulated, while in the case of ownership over stock (resources, things) it might be unconstrained.

\textsuperscript{25} I claimed in chapter I that the economics of property rights is not a normative theory, while now I am introducing the principle that might be interpreted as a normative principle. The argument in chapter I was that the economics of property rights was not capable of producing a comprehensive policy program. However, the assessment of an economic system basically follows the criteria of efficiency, though it will be shown that the economics of property rights recognised other criteria as legitimate and valuable as well.
one camp frequently distance themselves from the other). Both frameworks explore the preconditions that affect efficiency in the use of resources. This is a practical purpose of the science of economics, and one of the central problems of the philosophical analysis of property. Aristotle discussed common and private property and concluded that privately owned land would be more efficiently used than common property. The increase of efficiency of the use of a resource was also considered a priority across the countries in transition and it was the central goal of privatisation. The ideas of equality and solidarity - which were official ideological principles of communism - were considered corrupted and were rejected. These principles, together with collective ownership, were blamed for the relative economic backwardness of socialism in comparison to capitalism. However, it is not possible to separate the problem of efficiency from moral, ideological, political and other constraints that shape a property regime. The economics of property rights analyses the effect of social arrangements on the efficiency of the use of resources. In order to capture comprehensively the process of economic transition from socialism in general and the process of privatisation in particular I will in the following chapter introduce the principles of property rights economics.

26 Actually, Aristotle is to some degree ambiguous: “Property should be in a certain sense common, but as a general rule, private; for, when everyone has a distinct interest, man will not complain of one another, and they will make more progress.” Yet Aristotle notes possible advantages of common use of property in “well ordered states” and among friends: “It is clearly better that property should be private, but the use of it common; and the special business of the legislator is to create in men this benevolent disposition.” (Aristotle 1999, Book II, Chapter V, page 28)
Chapter III
An alternative understanding of property

The Nirvana scenario, a neoclassical approach to the transition from socialism, which relies on the traditional concept of property, was - at the end of chapter II - criticised from the position of the economics of property rights only in general terms. The rush to control resources (initial appropriation with no prior consent) was analysed briefly. The purpose of this chapter is to discuss the concept of property and to introduce the insights developed by the economics of property rights that, I will suggest, enable us to attain a more comprehensive understanding of privatisation and the transition from socialism.

The term the economics of property rights in this research covers Ronald Coase’s (1960/1990) seminal analyses of the economic aspects of property and includes occasionally divergent approaches such as law and economics; information asymmetry and principal-agent models; and particularly what is known as “new institutional economics”\(^1\). Since the economics of property rights has been considered “still in the process of creating its own mainstream” (Pejovich 2001, p. xiv) an understanding of it as a comprehensive and consistent theory might be a problem. The goal here is to outline those basic concepts and principles that are reflected in all of these approaches.

Its relationship to the neoclassical framework, which has been still usually considered mainstream economics, is decisive. Some scholars see the economics of property rights as a mere expansion of the neoclassical approach to the investigation of institutions. Alchian’s and Demsetz’s (1972/1999) analyses of the ownership structure of the firm and of the evolution of property regimes, which will be presented later, might fit this characterisation. On the other hand, it is frequently claimed that the property rights approach opens an opportunity for the development of a fundamentally new theoretical paradigm.\(^2\) While

\(^1\) Oliver Williamson (1975) coined the term ‘new institutional economics’ (Klein 1999). Douglas C. North investigated the development of economic systems, which is my great concern here, from the position of new institutional economics.

\(^2\) See the Nobel Prize Lectures of Ronald H. Coase (1991), Douglass C. North and Joseph E. Stiglitz (2001)
neoclassical economics assumes a convergence of economic systems, in reality they differ (North 1990, p. 6). The diverging transitions from socialism are an obvious example. The early analyses (Demsetz 1967, North and Tomas 1970) of the formation of property rights, which assumed that the choice of institutions follows the principle of efficiency, still belonged to the neoclassical framework. Then the question arose as to why some countries succeeded in achieving an efficient market and others did not, though the programs that were implemented were similar. New institutional economics now claims the capability to understand the divergent paths of development of economies: the dependence on past decisions (path dependency) and various preferences, not only efficiency, are taken into account when the formation of institutions takes place.

Basically, the economics of property rights considers that neoclassical economics ignored the incentives that follow from alternative institutional structures; that an analysis of the economic aspects of property rights, of their causes and of their effects, was neglected. Consequently, the economics of property rights can be considered in two different ways: it might be considered a mere addendum to the neoclassical approach; also, it can be argued that the economics of property rights opens a completely new horizon in which the space occupied by neoclassical economics is only limited. This dual attitude towards neoclassical economics affects the interpretation of how significant the key findings of the economics of property rights are. Generally, those who incline to the neoclassical approach downgrade the importance of the principles unveiled within the property rights investigation. My purpose here is to analyse the applicability of these concepts for the understanding of the transition from socialism. The explanation why and how institutions emerge will hopefully improve our understanding of privatisation and of divergent paths of the transition.

Chapter III and chapter II share similar subjects and a parallel structure. At the beginning of chapter II the traditional concept of property was considered as a twofold relationship, the relationship between a person and a thing and the relationship between persons in regard to things. An understanding of property rights within the framework of the economics of property rights is the subject of the first section of chapter III. The analysis of the Coase Theorem and its consequences, in the next section, investigates the distinction between the concepts of the market in neoclassical and property rights economics. These understandings of the market diverge because of the distinctive concepts of property that the two views take. The third section of chapter III introduces a new
criterion for distinguishing individual and collective ownership; then discusses cooperative activity; the ownership structure of the firm; and the evolution of property regimes. These subjects correspond to the issues that were discussed in Chapter II: what makes an owner; what the distinction is between public and private property; how to justify an initial appropriation.

1. The new understanding of property

The economics of property rights focuses on the economic aspect of property. Let me initially offer a definition: Property rights over particular assets represent the powers to capture income from these assets.³ It is not easy to comprehend consequences of this understanding of property rights from the traditional concept of property, which was in chapter II defined as “actions that individuals can take in relation to other individuals regarding some ‘thing’” (Ostrom 1999). The property rights definition takes care of income from resources. For the purpose of an illustration it would be useful to recall from the bundle of property rights that was presented in chapter II, the right to exclusion. This right is an example of what I will refer to as a costly right. If a resource is not protected from an intrusion, the power to capture income is lower. The economic analysis of property rights focuses on the costs of property rights and the costs of the exchange of property rights. I use the term costliness of property to cover all aspects of the costs of property rights.

1.1 The costliness of property

The costliness of property is a key issue of the new understanding of property rights.⁴ Every property consists of a number of attributes. Land may be used for rearing cattle, cultivating crops or building a house. The quality of soil varies. Some land is closer to a river; other land is exhausted. It is not possible to estimate at first glance whether some land is adequate for a particular form of production. It may require a costly adventure over several years of attempts with various types of production. Using modern agricultural instruments it is possible to identify the quality of soil. Output might be estimated but it unavoidably varies. This investigation is costly as well. The costliness of property follows from the variability of the economically relevant attributes of assets that are costly to measure.

³ Barzel (1989, p. 2): “Property rights of individuals over assets consists of ... the powers to consume, obtain income from, and alienate these assets.”

⁴ This explanation of costliness of property relies on Barzel (1989)
Additionally, Coase (1960/1990) noted that using land for a particular purpose might be prohibited since it might harm a neighbouring property. The right to capture income from property also has to be protected from intruders. Attributes that are too costly to measure or to protect are unavoidably placed in the public domain; they are exposed to “open access”. Valuable mineral resources might be under the surface of someone’s agricultural land but it may be too costly for him to investigate and use them. But not for a multinational corporation or for several of them; they may investigate the attributes of resources and compete for them. When a transaction is concluded the winning corporation has access to a valuable part of the resource, which is not then available to other competitors, as if it was placed “free of charge” in the public domain. The costliness of property rights that follow from the variability of the attributes of assets, which was not considered in the neoclassical concept of property, is crucial for every arrangement concerning property rights, for example for the appropriation and the exchange of property rights.

1.2 Three characteristics

Three characteristics of property rights follow from the costliness of property: that property rights are not absolute; the distinction between economic and legal property rights and the distinction between property and property rights. The analysis of a property rights regime should take into account these three characteristics of property rights and I will illustrate them using, a little bit in advance, examples from the process of privatisation in Croatia.

After an initial allocation of shares to employees and citizens in the first phase of privatisation in Croatia the shareholders encountered drastically different costs of using their rights to obtain an income from their assets. Though all shareholders had the same legal rights it was cheaper for managers to investigate the attributes of assets and to capture a flow of income. This is a basis for the distinction between legal and economic property rights, which is emphasised among the authors who belong to the economics of property rights school. The Slovenian economist Alexandar Bajt, who claims that the distinction between economic and legal property rights was first introduced by him in 19535 in regard to the analysis of the economic effects of self-management, uses the famous example

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5 It is often claimed that the distinction between economic and legal property rights was introduced in Alchian (1965): “Some economics of property rights”. Alexander Bajt (2001) concludes that the distinction was drawn much earlier, in 1953.
of the team of coolies who hire and pay an overseer to whip them “as they strain at their harness” pulling boats upstream, to conclude that economic ownership exists even if a firm is not incorporated. Barzel (1989, p.2) comes to a similar conclusion: “Legal rights, as a rule enhance economic rights, but the former are neither necessary nor sufficient for the existence of the latter.” Bajt concludes that *individual economic ownership* (that is individual power to use the flow of income from a resource), exists even in socialism.

From their costliness it follows that property rights, if conceptualised as the power to obtain an income, are not absolute; property rights may be changed by human action, they may be increased or abandoned. The fact that shareholders (citizens, workers, employees and even politicians), having the same legal rights, encountered different costs in obtaining income from resources, was one of the biggest problems of the processes of privatisation. In Croatia and Slovenia the problem was approached in different ways. In Slovenia a temporary ban on the exchange of shares was introduced to equalise the economic ownership of those whose power to obtain income was lower, because of a lack of knowledge or for other reasons, and of those (mostly managers) who enjoyed an advantageous position to capture the flow of income. In Croatia many individual shareholders abandoned their assets: it was too costly to capture an income from them. Hence, economic property rights are not absolute since they can be changed by individuals’ actions. A resource may be abandoned if the costs of its acquisition, management and use exceed the benefits. Much as does Coase, Barzel (1989, p.2) concludes: “Economists’ past failure to exploit the property rights notion in the analysis of behaviour probably stems from their tendency to consider rights as absolute.”

Finally, Coase (1960/1990, p.155) insists that property rights (and not property) are to be conceived as a factor of production. In the concluding paragraphs of his seminal paper “The Problem of Social Cost” Coase wrote:

> We may speak of a person owning land and using it as a factor of production, but what the land-owner in fact possesses is the right to carry out a circumscribed list of actions. The rights of a land-owner are not unlimited... And although it may be possible for him to exclude some people from using ‘his’ land, this may not be true of others. For example some people may have the right to cross the land. Furthermore, it may not be possible to erect certain types of building or to grow certain crops or to use a particular drainage system on the land. This doesn't come about simply because of
governmental regulation. It would be equally true under the common law. In fact, it would be true under any system of law. (p.155)

The economic property rights are defined, and the essential features of the new concept of property: the costliness of property, the distinction between legal and economic property rights, the distinction between property and property rights and the understanding that the economic property rights are not absolute, that they depend on individual action, are introduced. Further analysis, in the second part of chapter III, is focused on the relationship between property rights and a market and on the question of why market institutions emerge at all. The description of the Coase Theorem and the Coase world is the basis of this investigation. In regard to the market, the relationship between neoclassical and property rights economics comes significantly into view when we look at this material. Though this discussion is to some degree extensive, I would like to explain the original context in which the analysis of property rights was developed. The description of their origins enabled me to distinguish these basic insights of the economics of property rights which are incorporated in all forms of its further development.

2.1 The Problem of Social Cost

The publication of “The Problem of Social Cost” (1960/1990), where exchange under the ideal condition of zero transaction costs is analysed, has been considered a beginning of a new analysis of property. It was claimed that “The Problem of Social Cost” became the most cited paper in all of economics (Halpin 2007, Medema & Zerbe 1999), though it was not completely clear what Coase’s most famous paper was about. Coase (1991) himself acknowledged that at the time of writing of “The Problem of Social Cost” he didn’t recognise that his ideas might be of general significance for economic analysis. This became apparent to him only later as a result of conversation with Steven Cheung. On the basis of the insights conveyed in the paper, only later were the phrases the Coase World and the Coase Theorem formulated, however not by him (Coase 1990, p. 14).

6 Traces of the new approach were later found in the works of other theorists and even in Coase’s earlier works. The model of zero transaction cost exchange was anticipated in the earlier paper “The Federal Communication Commission” from 1959; Coase himself refers in “The Problem of Social Cost” to the work of Frank H. Knight

7 According to Coase (1990, p. 14) the phrase the Coase Theorem was formulated by George Stigler
The subject of the paper was the analysis of a market solution and an administrative solution for the problem of externalities: noise and vibrations from a confectioner’s machinery disturb the work of a neighbouring doctor; ashes from the fire of a steam train set fire to crops along a rail line; a factory emits smoke into the atmosphere of a residential area. Coase’s initial motive was a critique of A.C. Pigou's solution of the problem of externalities. In the case of the noise and vibrations from confectioner’s machinery, which disturb the work of the doctor in the neighbourhood, Pigou’s approach proposes a taxation of the business that inflicts the damage (the confectioner). The same is proposed for the train that fires the crop along the rail, and for the factory that emits smoke into the atmosphere of a residential area. Under the assumption of the distinction between private and social product Pigou’s solution for the problem of externalities was an imposition of the duty (taxation) on the business that causes damage to compensate the damaged side. It was supposed that the punishment of the damaging business and the compensation to the damaged side increases the social product.

While at first sight the above solution seemed reasonable, Coase showed that Pigou's distinction between private and social product was incorrect. Instead of the comparison of private and social product Coase proposed the comparison of total products under alternative social arrangements. Coase recommended an opportunity cost analysis of alternative social arrangements: in society A the producer that does harm is liable; he is not liable in society B; in society C a negotiation is obligatory. Coase demonstrated that the Pigou's taxation might even prevent the achievement of the maximum of production if the business that inflicts the damage was more profitable than the harmed production (in this case Coase specifically analysed the relationship rail-company and farmer). The taxation imposed on the residents might impel them to move from the vicinity of the factory. If the removal was cheaper than the installation of the devices for smoke reduction then the total product could be higher (Coase 1960/1990, p. 133 – 153). On the other hand, negotiation and market exchange under the condition of zero transaction costs always enables the maximisation of production. Coase criticised Pigou’s tradition, which relied on administrative intervention (taxation) in the economy.

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8 Externalities represent the effects of production or of trade on a third party. Thorough analysis shows that this concept is in fact ambiguous; almost everything is externality for something (except in the case of Crusoe’s actions before Friday arrived). The economics of property rights is characterised by a cryptic language and a vagueness of concepts such as transaction costs or institutions. However, it doesn’t imply that it would be easy to get rid of them.
Although in what follows I will be stressing another issue opened up by Coase’s work, there is some merit in this interpretation of Coase’s paper. Indeed, this interpretation represents the initial intention of Coase himself, as it was explained above. This interpretation also can apply to the transition of socialism that relied heavily on the administrative coordination of economic activity. However, it was mentioned that Coase’s paper suggested ideas that “might be of general significance for economic analysis”, and to these we will now turn.

2.2 The Coase Theorem

From the analysis of the examples conveyed in “The Problem of Social Cost”, much further-reaching conclusions were derived. The so-called Coase Theorem is the most important of them. It was already mentioned that the Theorem was not formulated by Coase. A further detail of significance is that one definitive formulation of the Coase Theorem doesn’t exist at all. It in fact denotes a number of conclusions derived from Coase’s analysis of significant examples. The formulation that in the simplest way synthesises the essential features of Coase’s analysis suits the purpose. It states:

In a world of zero transaction costs, the allocation of resources will be efficient and invariant to legal rules of liability, income effects aside. (Zerbe 1980, p. 84)

The formulation incorporates:

(1) **The efficiency hypothesis**: Regardless of how rights were initially assigned, the resulting allocation of resources will be efficient.
(2) **The invariance hypothesis**: The final allocation of resources will be invariant under alternative assignments of rights.

It is particularly important to note that maximisation of production and invariant allocation of resources follow *regardless of allocation of liability*; that is, regardless of whether the damaging business (confectioner, factory, rail company) was liable or not. It might be formulated as follows:

(3) It doesn’t matter whether the law imposes liability on an activity or not; whether the activity goes ahead or not is a matter of efficiency.

From conclusion (3) it was derived that courts should mimic the market: courts should determine issues of liability on the basis of what the market in ideal
conditions would determine as the efficient outcome of the dispute between the parties (Halpin 2007, p. 332).

However, zero transaction costs were the key precondition for the Coase Theorem being correct. It is this which is responsible for the consequence that the initial distribution of property rights doesn’t affect the final allocation of resources.

(4) In the absence of transaction costs, the allocation of resources is independent of the distribution of property rights.

Here I would like to recall the quote from the beginning of chapter I that expresses the belief of Croatian economists that resources would come into the hands of entrepreneurs regardless of the initial allocation of assets and of the institutional structure. It should be noted that reasoning analogous to that which was expressed in the Coase Theorem is not unusual in economics. The Modigliani-Miller theorem from 1958 states that if capital markets are perfect it is irrelevant for the value of the firm whether business activity is financed by debt or by equity. Similarly, it is irrelevant whether taxes are imposed on producers or on consumers in terms of resource allocation; the same is the case with respect to the alternative ad valorem taxes or taxation per unit (Allen 1999, pp 904-905). A perfect market is an accepted precondition.

2.3 Two lines of interpretation

If understood as an expression of general equilibrium the Coase Theorem is regarded as stating the obvious, as trivial. On the other hand, the conclusion that the assignment of liability doesn’t matter for the allocation of resources and the maximisation of production was assessed as surprising, even miraculous; the consequences of the analysis of Coase’s examples were considered “heretical” and “perverse”. As for the unrealism of the Coase world, it was seen a circumstance “in which competitive markets are normally considered” (Medema & Zerbe 1999, p. 893). The Coase Theorem was understood as a proof that a market economy – if not disturbed – efficiently allocates resources; at the same time the analysis of

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9 See chapter I, section 1.1: Two quotes. After the initial allocation it is assumed that assets come into the hands of their most efficient use. It is even implied, though not explicitly that the development of institutions would follow the principle of efficiency.

10 Halpin (2007, p. 323) quotes Stigler that “Coase taught us, what of course we should already known”, and Posner that “Coase is living proof of Whitehead’s dictum that ‘it requires a very unusual mind to undertake the analysis of the obvious’.”
the Coase Theorem was used by others as the basis of a criticism of Walrasian economics (general equilibrium theory).

Two lines of the interpretation of Coase might be identified. The first line accepts the assumption of zero transaction costs and within this proposition some try to refute while others try to prove the Coase Theorem (Medema & Zerbe 1999, pp. 840 - 855). The second line explores the idea of transaction costs. It will be shown later that the second line is also divided between those who consider transaction costs an external obstacle to the functioning of a market, similar to the relationship between friction and free fall and those who relate transaction costs to property rights, i.e. transaction costs are taken to be essential to the inner structure of property and market. Though all the lines of analysis of the Coase theorem are sometimes intertwined the option that relates transaction costs to property rights is – naturally – in the focus of my present treatment.

It is to be noted that all the above conclusions from Coase’s examples directly relate to property rights: the problem of liability; the allocation of resources; and the problem of externalities. I argue that the two lines of interpretation of the Coase Theorem relate to the two analyses of property rights, the traditional one and the new one. In my opinion, a useful way to capture the relationship between the Theorem and property rights is to re-examine Coase’s examples.

2.4 A short presentation of Coase’s examples

Coase’s original presentation of his examples is not elegant in comparison to the later systematisations. I will use Halpin’s (1990 pp. 326-327) systematisation to present the familiar case of roaming cattle that destroy a farmer’s crop.

(A) The profit of the production that inflicts the damage (the ranching) is higher than the damage (the destroyed farmer’s crop). The rancher continues production regardless of being liable for the damage or not. If the rancher was not liable (A1) there were no barriers for him to continue production. If liable, (A2) the rancher buys out the right to continue production; since the profit is larger than the damage it is in the interest of the rancher to pay some amount that is higher than the value of the damage and less than the value of his profit. In both cases, regardless of the allocation of liability, production is maximised (total production minus the value of the damage) and the more efficient production continues.
(B) The profit of the rancher is lower than the value of the damage; i.e. rancher’s gain when cattle roams around is lower than farmer’s profit if cattle doesn’t damage his crop. If the rancher is not liable (B1) then the farmer, who is more productive, “bribes” the rancher to stop production. If the rancher is liable (B2) he doesn’t have enough to compensate the farmer; hence the farmer continues production. Regardless of legal liability the more efficient production continues and the allocation of resources remains the same.

It is obvious that cases A and B are similar; if the damaging business was not liable it is in both cases denoted as (1), and if the damaging business (ranching) is liable it is denoted as (2). The outcomes from the examples are confusing and for untrained people not easy to comprehend since an alternative systematisation exists: a more efficient business is liable (X) and it buys out a less profitable business; the more profitable business is not liable (Y) and it continues. Therefore, the matrix may look as below:

**Table 2**

<table>
<thead>
<tr>
<th>The Coase Theorem</th>
<th>(X) The damaging business is more efficient</th>
<th>(Y) The damaging business is less efficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) The damaging business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>is not liable</td>
<td>(1X) The damaging business continues</td>
<td>(1Y) The damaging business buys out the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>right to continue</td>
</tr>
<tr>
<td>(2) The damaging business</td>
<td>(2X) The damaged business buys out the</td>
<td>(2Y) The damaged business continues; the</td>
</tr>
<tr>
<td>is liable</td>
<td>right to continue</td>
<td>damaging business doesn’t have the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>resources to buy out his right</td>
</tr>
</tbody>
</table>

The cases in cells 1Y and 2X that suppose negotiation, trade and exchange of property rights are of importance for the analysis of the world of positive transaction costs.

The seductiveness of Coase’s examples – in my opinion – follows from the fact that people frequently behave as was assumed in the analysis, they buy out their right to continue their business even if they make a (minor) damage. But sometimes they do not. This is the question: why sometimes is it the case that the more profitable business doesn’t successfully buy out the right to continue production? Coase implies that the reason is transaction costs, but he didn’t define what transaction costs are. In his later years, in the Nobel Prize Lecture, Coase (1991)
said: “[There are] costs of using the pricing mechanism. What the prices are has to be discovered. There are negotiations to be undertaken, contracts have to be drawn up, inspections have to be made, arrangements have to be made to settle disputes, and so on. These costs have come to be known as transaction costs.” The subjects of the following section are: What are transaction costs, and what is their relationship to a market and to property rights?

2.5 Transaction costs

It was concluded above that the interpretations of the Coase Theorem diverge in regard to transaction costs. The idea of transaction costs originates from the paper “The Nature of the Firm” where Coase (1937/1990, p. 37) attempted “to discover why a firm emerges at all in a specialised exchange economy”, i.e. why economic activities are sometimes coordinated hierarchically by an entrepreneur (capitalist) in the form of vertical integration\footnote{Coase (1937/1990, p. 36), uses the following examples: “In a department store, the allocation of the different sections to the various locations in the building may be done by the controlling authority or it may be the result of competitive price bidding for space. In the Lancashire cotton industry, a weaver can rent power and shop room and can obtain looms and yarn on credit. This co-ordination of the various factors of production is, however, normally carried without the intervention of the price mechanism”. For Williamson (1971/1999) “[t]he standard example is the integration of iron and steel-making.”. Klein, Craford and Alchian (1978/1999) analyse the case of a publisher who integrates a printing service although it can be purchased in a market} and not by means of the price mechanism. According to Coase a firm and a market are two dominant forms of a coordination of economic activities.\footnote{It is to be noted that Coase concluded in “The Problem of Social Cost” (1960/1990, p 117) that “[t]he government is, in a sense, a super firm (but of a very special kind).”} Coase (1937/1990, p.38) concluded that the emergence of the firm was the response to “a cost of using the price mechanism” – transaction costs.

The definition of transaction costs varies from the comprehensive but tautological, that transaction costs are anything that might prevent the achievement of a Pareto optimal solution (market efficiency), to the short list of costs of search, negotiation, and contract enforcement (Schlag 1989, p. 1662). Allen (1999, p. 898 and p. 901) distinguishes a neoclassical understanding, where transaction costs play a role of not such a great significance, and a property rights approach where transaction costs are substantial. In the neoclassical understanding:

- transaction costs are the costs resulting from the transfer of property.

While a property rights approach defines them as
- the costs of establishing and maintaining property rights.

However, these two definitions of transaction costs are very close, although perhaps not completely distinguishable in every case. I will first comment on the neoclassical understanding of transaction costs and controversies that it encounters.

### 2.5.1 The neoclassical understanding

In the neoclassical interpretation, if it considers the problem at all, transaction costs simply disturb a perfect market exchange in a way similar to that in which air resistance disturbs gravitational force (perfectly lawful) in the case of free fall (Schroeder 1989). Though always present, transaction costs are exogenous to market exchange. The introduction of the concept of transaction costs is no more than the recognition that in the real world barriers to the smooth operation of pricing mechanisms exist.

Following the neoclassical understanding the transition from socialism aims at a reduction of transaction costs and a liberalisation of the price mechanism to allocate resources efficiently. This understanding of transaction costs encounters a problem. Since the investigation of market prices is counted among transaction costs, then administratively fixed prices decrease some transaction costs. Consequently, the dismantling of the administrative control of prices at the beginning of transition might be counted as involving an increase of transaction costs. Actually, this was one of the explanations of the economic crisis at the time of the most radical reforms in the countries of former socialism (Collombato & Macey 2001). As a consequence both the liberalisation of the price mechanism and the fixing of prices (or any other form of price regulation) may decrease and increase transaction costs.

The understanding that assumes a perfect market and transaction costs that simply disturb it encounters conceptual difficulties. In this case, transaction costs depend on the definition of a market. For example, costly consultation with an attorney might be conceived as a transaction cost, which could be minimised with changes in the legal system. An attorney, however, treats his knowledge as a product for market exchange. A transaction cost in one market becomes in the other one a product for exchange. If a perfect market is to be achieved in any case, the decision as to what is a transaction cost becomes arbitrary. Consequently, regulatory constraints, like licensing and product specifications may make for less
costly market transactions (Schlag 1989, p. 1696); a perfect market is both a free market and a regulated market.

Schroeder (1998, p. 516) notes that the explanation that assumes that the Coase Theorem describes how a perfect market works, while transaction costs only disturb it, lacks a description of a perfect market (see Schroeder’s explanation below). This is why, in my opinion, Coase proposed an opportunity cost analysis of different social arrangements.\(^{13}\) The Nirvana scenario (chapter II), a neoclassical program of the transition from socialism, was supposed to work in all societies. Its assumed universality was a consequence of the lack of a detailed description of an absolutely efficient market, which was the benchmark that was to be achieved. If the transition from socialism is designed on the basis of this understanding of the market it would be reasonable to expect unforeseen consequences.

Since socialistic administration imposed heavy barriers to the functioning of pricing mechanisms, it was implicitly assumed that a laissez faire market, which was free of administrative interventions, was the closest to the world of zero transaction costs. Even before the period of transition Coase noted that such reasoning would be a misunderstanding of his intention. As an ideal market lacks details it would be impossible to compare it with any real market\(^{14}\):

> A second feature of the usual treatment of the problems discussed in this article is that the analysis proceeds in terms of a comparison between a state of laissez faire and some kind of ideal world. This approach inevitably leads to a looseness of thought since the nature of the alternatives being compared is never clear. In a state of laissez faire, is there a monetary, a legal, or a political system, and if so what are they? In an ideal world, would there be a monetary, a legal, or a political system and if so, what would they be? The answers to all these questions are shrouded in mystery and every man is free to draw whatever conclusion he likes. Actually, very little analysis is required to show that an ideal world is better than a state of laissez faire, unless the definitions of a state of laissez faire and an ideal

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\(^{13}\) Coase (1960/ 1990 p. 153-54): “Economists who study problems of the firm habitually use an opportunity cost approach and compare the receipts obtained from a given combinations of factors with alternative business arrangements. It would seem desirable to use a similar approach when dealing with questions of economic policy and to compare the total products yielded by different social arrangements.”

\(^{14}\) In my opinion the implications from Coase’s analysis of the relationship between laissez faire and an ideal market may directly apply to the intentions of socialist reformers, though this conclusion may be challenged; finally, Coase wrote the above sentences long before transition.
world happen to be the same. But the whole discussion is largely irrelevant for questions of economic policy since, whatever we may have in mind as our ideal world, it is clear that we have not yet discovered how to get to it from where we are. A better approach would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one. (Coase 1960/1990, p. 154)

2.5.2 The property rights understanding

For the purpose of capturing the property rights understanding of transaction costs it would be useful to come back to the example of the rancher and the farmer, and cattle that damage crops. Assume that the rancher concludes that one more cow would give him 30 dollars profit and the crop damaged by an additional cow is usually worth only 20 dollars. Since in this case the rancher is liable (but in essence it doesn’t matter) he approaches the farmer to negotiate. There is a doubt: what if the cow damages crops worth 30 dollars, who pays for it? (This is what Barzel calls a variability of attributes of assets that is costly to measure.) The contract (customs, law) may stipulate that (1) the rancher pays 20 dollars or (2) the rancher pays for the damaged crop. Both types of contract have advantages and disadvantages for both sides. The farmer may propose a fixed price of 20 dollars, hoping that the cow would make less damage. There are uncertainties for both sides and a contract may not be concluded. I would like to recall Coase’s words: there are costs of using the pricing mechanism. There are negotiations to be undertaken, contracts have to be drawn up, inspections have to be made, arrangements have to be made to settle disputes, and so on. Transaction costs that follow from the costliness of property, that is from the variability of attributes of assets that are costly to measure, but also from preferences, may prevent an efficient market allocation of resources.

I argue that the costs that were mentioned that represent transaction costs logically follow from the costliness of property rights. Since property is costly, negotiations

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15 Barzel’s critique (1989, p.55) that Coases’s initial assumptions are contradictory, explains at the same time how property rights emerge: “Coase does not address the question of the conditions under which liability problems arise. Now, it is essential to recognize that variability is a necessary condition for liability; liability poses a problem only in the presence of a variability that is too costly to eliminate.” That is, without variability of assets there is no costliness of property and there is no liability (property rights).
and making contracts are therefore costly. The property rights definition of transaction costs as the costs of establishing and maintaining property rights covers almost all examples of transaction costs.

In the following sections I will explain that different customs in regard to trade, i.e. various cultural and social incentives and restrictions of market exchange could be understood as solutions for problems of the costliness of property that could not be captured by a pricing mechanism. I will later argue that institutions somehow create a pricing mechanism, though some institutions may also impose barriers to the efficient allocation of resources.

3. The new understanding of the market

Behind the two interpretative lines of the Coase Theorem lie two different concepts of property: the world of zero transaction costs ignores the costliness of property. As a consequence, the market that was denoted as a perfect market lacks essential elements of a competitive market. If transaction costs are conceptualised as "anything that might prevent the immediate perfect allocation of resources" the features that enable competition are on the list of transaction costs: strategic behaviour, preferences, and even time and space.

It is usually stated that the world of zero transaction costs assumes perfect information. This is not easy to comprehend. Everybody should know everything. Coase concluded that for a market to efficiently allocate resources the rancher must know how to improve the farmer’s production; the rancher should know whether a crop that is more resistant to the herd’s transgression exists; if it does exist and the rancher knows about it, this sort of crop might be cultivated, thus it would decrease damage and maximise production. This requirement seems too strong for minimising the costs of bargaining, negotiation and contracting. There is no doubt that the costs of bargaining are really zero if everybody knows everything, if bargaining in this case exists at all.

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16 However, it is possible to argue for the opposite direction of causality: Since negotiation is costly, acquisition of property is costly on the market. In any case, costliness of property may not be neglected. Barzel synthesises: Transacting is costly, property is costly.

17 George Stigler concluded that “market may be perfect and monopolistic or imperfect and competitive”. Here quoted from Schroeder (1998)

18 Coase (1990, p.178) indicated that in some cases still not existent information should have been known if a perfect allocation of resources is to be achieved
This modelling of a market exchange doesn’t seem sensible to me. Schroeder (1998, p. 516) concludes: “The perfect market is an extraordinary world with no differentiation, no time, no space, no desire, no exchange, no objects – no subjectivity...the perfect market is not merely impossible, it is literally unimaginable and unspeakable.” Coase (1990, p. 15) agrees: “In such a world the institutions which make up the economic system have neither substance nor purpose. Cheung has even argued that, if transaction costs are zero, ’the assumption of private property rights can be dropped without in the least negating the Coase Theorem’ and he is no doubt right. Another consequence of the assumption of zero transaction costs, not usually noticed, is that, when there are no costs of making transactions, it costs nothing to speed them up, so that eternity can be experienced in a split second.”

As for the above conclusions that were derived from the assumption of zero transaction costs, Coase (1990, p. 177) emphasises that courts could not know what the ideal market would determine (nor anybody else since a perfect market lacks details). The neglect of costs characterises also the conviction that was widespread in the process of privatisation in Croatia that a free market would allocate resources at the place of their most efficient use regardless of the initial distribution of property. This reasoning relied on an unreal ideal market (the above conclusion 4).

Coase (1990 page 174) distanced himself from the solutions derived from the zero transaction costs model and particularly from calling it Coase’s world: “The world of zero transaction costs has often been described as a Coasean world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave.” Coase was disappointed by the commentators on his work who devoted too much attention to the analysis of the world of zero transaction costs (the first interpretative line). Though this was understandable to him because the world of zero transaction costs “is the world of modern economic analysis, and economists therefore feel quite comfortable handling the intellectual problem it poses, remote from the real world”. (Coase 1990 pp. 14-15) Instead, Coase proposed a comparison of alternative real institutional structures.

3.1 Markets with costly property rights

The historical evidence about the development of Californian trespassing law, which regulated property rights relationships between ranchers and farmers, is illustrative
At the beginning there were no laws that restricted a rancher from trespassing over a farmer’s land. Fencing was expensive. It was calculated that the value of fences was several times higher than the total market value of herds. There was a possibility that a farmer might negotiate with a rancher by buying out his herd. However, if a contract with one rancher was achieved it wouldn’t prevent other herds owned by other ranchers from trespassing. Consequently, the costs of negotiation were unbearable for farmers. As for the rancher if he wanted to buy out the right of trespassing, he would negotiate with only one farmer. By the changing of law and by the changing of property rights, the costs of negotiation significantly decreased and a more efficient market allocation of resources was enabled. The changing of the law so that trespassing became penalised and farming protected from damage significantly increased the production of crops and meat. Since the attributes of resources are different, i.e. cattle moves around and crops do not, the initial assignment of property rights matters. Following Barzel’s reasoning, liability in this case is to be allocated to the rancher since the variability of attributes of cattle is costlier to measure than the variability of attributes of crops.

The world of positive transaction costs is now to be analysed. This doesn’t mean to construe market exchange as it ought to be. A real market exchange is rational despite the variability of attributes of assets and the costliness of property.\textsuperscript{19} That is, an idealisation, like the assumption of zero transaction costs, is not a necessary precondition for the rationality of market exchange. The section 2.5.2 \textit{The property rights understanding} and the above example of changes of Californian trespassing law explain that the costliness of property affects the initial assignment of liability (i.e. the emergence of property rights). The sections 3.2 and 3.3 of this chapter analyse the property rights explanation of the emergence of formal and informal rules of exchange.

\subsection*{3.2 Market transactions}

According to Barzel (1989, p. 53), there is a disagreement about the term “market transaction”. The first interpretation sees market transactions as “properly and

\textsuperscript{19} Hegel (2001, paragraph 189, page 160) identified a variability of attributes of assets as a starting point and as a fact that should not be neglected: “The soil is more fertile in one place than another; years differ in their yield, one man is diligent while another is lazy.” It implies that satisfaction of universal wants such as those of food, drink and clothing depends on an accident. Through labour and interaction with others, who are “at this stage” proprietors of external things, satisfaction of universal wants gets its objectivity, concludes Hegel. It is a task of political science (Hegel refers to Smith, Ricardo and Say) to detect the laws in this mass of accidents and arbitrary things. For the thesis that Hegel already laid down the contours of the property rights economics (new institutionalism) see Hunt (2006).
fully priced transactions, free, therefore, of distortions; in other words, in such transactions individual buyers and sellers bear the full costs of their actions.” The smooth functioning of an efficient pricing mechanism is disturbed only by occasional “externalities”. This is, according to Barzel, a pervasive understanding. However, some “distortions”, for example strategic behaviour, preferences and so on, are not occasional accidents, they are “instances of general case”, they are in fact basic to the functioning of a competitive market.

The property rights view includes in the term “market transaction” further elements. Market transactions, once concluded, leave no obligations between sides in the exchange; for example no obligation on the seller for the quality of product (or on the buyer for the value of money). Barzel formulates that these transactions are “governed by *caveat emptor*. A responsible buyer investigates the attributes of the assets (or commodities) to be acquired. A responsible seller discloses characteristics of the product or assumes liability or provides a guarantee. The solutions depend on (1) the attributes of goods; they vary across (2) markets and (3) economic cultures. “Since *caveat emptor* transactions are costly, they are used only under narrowly circumscribed conditions. Would-be buyers of commodities whose sale is subject to *caveat emptor* will not part with their money before either inspecting the commodities sufficiently to convince themselves that they are not throwing their money away, or, alternatively, satisfying themselves of the sellers’ reputation, which requires that the sellers have previously invested in it.” (Barzel, 1989, p. 54) In this view market transactions cannot be reduced to the pricing mechanism.

Consider a further example. Different rules regulate the selling of fruit and the selling of household appliances, or a real estate market and a stock market. It is allowed, though not in all societies or with all sellers, that cherries can be tasted before being purchased. However, a quality complaint and the return of a few hundred grams of cherries is a rare occurrence.

### 3.3 The genesis of the rules of exchange

Rose reports that at first the *caveat emptor* principle guided house selling in the US: “The purchaser was thought to be perfectly capable of inspecting the property

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20 Barzel’s mentioning of reputation implies that market transaction inevitably includes a moral aspect. There is no trade off between efficiency and morality of the market. Every market transaction incorporates a moral component. Sometimes the selling of a pig in a poke is considered morally acceptable (for example when the amount is small) in another case it is not. This is why it was traditionally claimed that trade introduces people and nations. As Hegel points out, exploration of resources with the aim of the satisfaction of wants achieves objectivity through interaction with others (see the note above).
and deciding for himself whether he wanted it, and if anyone were foolish enough to buy a pig in a poke, he deserved what he got... the seller had no duties to disclose anything at all.” (Rose 1994, p. 202, chapter VII: Crystals and Mud in Property Law) Because an imperfectly inspecting buyer might be stuck with a house that was flooded twice a week with the neighbour’s sewage, the doctrine “a loss disproportionate to lapse” prevailed: it was assessed that a slight omission should not be “punished” so strongly. Without such an assessment the trade might become completely trapped. Consequently, the seller was required “to tell a buyer about material problems known to the seller but indiscernible by the purchaser even upon reasonable inspection.” As an extreme consequence, a California court ruled that the sellers should have informed the buyer that a mass murder had taken place in the house a decade before (Rose, 1994, pp 202-203). However, the solutions differ across countries, cultures and traditions depending also on what was considered reasonable or efficient, or just.

Rose analyses the interaction between formal and informal rules of exchange, between customs and moral principles, courts’ decisions and legal regulation. At the time when formal regulation tends to specify principles, the participants in the transaction simplify the exchange, and vice versa. Following the history of the English land register from Henry VIII onward, Rose concluded that there was no rule that could not be overused or abused. Some institutions work efficiently in small, close-knit communities, others are designed to facilitate exchange among strangers.

The pricing mechanism accommodates to all these costs, all this investigation into attributes of property, costs of enforcement of rights, allocation of liabilities, formal and informal institutions, customs and tradition that are called a delineation of property. Adjustment of prices to the costliness of property is costly as well; using the pricing mechanism is costly. Efficient pricing and allocation of land is different from efficient pricing of securities. An efficient pricing mechanism is not beyond space and time; the efficient pricing mechanism has to be created.

I will explain in chapter V (section: The moral issue) that Croatian economists propagated a variant of the caveat emptor principle for the emerging Croatian stock market. Soon the general public and a majority of individual shareholders assessed it unjust and disastrous for the resources involved (chapters VI and VII). Chapter VIII describes the interaction between formal and informal norms, legal authorities and participants in privatisation in Slovenia.
3.4. Short summary

A general framework of property rights economics has been outlined above. The transition from socialism to a market-based economy was concerned particularly with the distinction between individual and collective property and with the evolution of property regimes. Before discussing these issues from a property rights view I would like to systematise some findings from the above analysis.

Property rights should be conceived as a factor of production. To do so involves distinguishing legal and economic property rights. Economic property rights represent the power to capture income from a resource. A resource might be abandoned if the costs of its acquisition, of management, protection and of its use exceed the benefits. Property consists of a number of attributes. The costliness of property follows from the variability of attributes of assets that are costly to measure. The method of allocation of resources alternative to the market (firm and government) was seen as a consequence of the costs of using the price mechanism, that is, of transaction costs. Property rights economics connects transaction costs with the costliness of property rights. Costs of negotiation, bargaining, discovering prices, and costs of contracting are connected with the costliness of property. Distinct economic cultures establish different solutions for the exchange of property rights. The idea of a costless pricing mechanism is senseless. A laissez faire market might be, and often is, a market with high transaction costs (depending on the attributes of assets). As for privatisation, the initial assignment of property rights matters for the efficient allocation of resources.

In my opinion section 3, the presentation of the market with costly property rights, which includes an explanation of the genesis of the rules of exchange, represents the most important aspect in my analysis. The costliness of property and the judgement of what is reasonable, what is efficient and what is just, firmly intertwined, jointly form an economic structure with no priority given to any of these causes. A just solution might stimulate trade and the efficiency of the allocation of resources; an efficient solution might be considered just. Two principles of just allocation might work efficiently in different cases: caveat emptor might be efficient in the case of buying cherries while an explicit guarantee can be efficient in the case of a real estate market; however, the requirement of explicit guarantee might be an unnecessary cost. The costliness of property requires that the principle of justice; customs; legal traditions and general beliefs (in short -
institutions) should be taken into account, even if the normative position is an increase of the efficiency of allocation of resources. They are not external to a market exchange. This complexity of institutions - the fact that the same institution in one particular circumstance increases the efficiency of the market allocation while in other contexts it works in the opposite direction - is the reason why North concluded that a theory of economic dynamics based on the economics of property rights comparable in precision to the general equilibrium theory and capable of creating a consistent and comprehensive policy of proposals concerning institutional change, doesn’t exist (see my discussion in chapter I, section 2.4). This is why Coase proposed a comparison of different economic arrangements. The conclusions developed within property rights economics shed a new light on the distinction between individual and collective ownership; on the ownership structure of the firm; and on the problem of the evolution of property regimes.

My suggestions related to these subjects will be presented below, though I cannot here, for reasons of space, offer a comprehensive analysis. In the following sections of this chapter I will survey ideas upon which I will be drawing, and which I will make use of, to illuminate the analysis in the subsequent descriptive chapters (IV to IX). However, there is nothing innovative in the presentation of these ideas, but, rather, I am simply putting before the reader ideas from the literature which – it seems to me – may be of value when we turn to understand what took place in Croatia and Slovenia.

4. 1 Individual and collective ownership

Privatisation was conceived as an assignment to individuals of assets previously governed collectively. Two distinctions are important. The controlling of stock is to be distinguished from the right to capture the flow of stock (income). Cooperative business activity by the owners of various inputs (labour, capital) is to be distinguished from collective ownership of one particular resource input. For example, land may be owned collectively, or an individual owner of some land may cooperate with the owner of the labour input in a sense that they make decisions collectively. In the case of **sole ownership** an individual controls completely all inputs necessary for business activity. The consequence of sole ownership is full reciprocity between the costs and benefits of ownership. The right to exclude (others from stock) strengthens the control of investment and can be expected to lead to the improvement of a resource (Rose, 1994, p. 105).
Sole ownership suffers from some disadvantages. The first is a lack of specialisation, which was identified already by classical economics. The second problem relates to the optimal allocation of resources: it is extremely improbable that assets were initially assigned to those who are most capable of exploiting them most efficiently. Reallocation of resources to the place of efficient use assumes market exchange. Barzel (1989, p. 51) concludes that this requires contracting between borrower and lender, between owner of labour and owner of capital (land, machinery equipment); this requires i.e. decomposition of property into its separate components (disintegration of property). This contracting is costly.

The sole-ownership arrangement is free of those contracting problems that arise when land and labour are not owned by the same individual; it may seem, then, that sole ownership should be the preferred method of operation. The sole-ownership arrangement, however, is subject to two sets of transaction costs associated with owning all of the inputs in a production process. The first set of costs arises because the pattern of ownership of productive non-human assets is extremely unlikely to match fully the ownership pattern of human skills that would have generated the highest output. Total output, then, can be increased if people exchange productive assets in order to arrive at a better match of resources. To accomplish this, owners of labour would have to borrow in order to buy the land with which to work. This would not occur unless transacting is reintroduced – here the transaction between borrower and lender replacing that between owner of labour and owner of land – and it cannot be determined a priori that the transaction between former two would yield a higher net gain than the transaction between the latter two. The second, equally important set of costs of sole ownership is due to the losses in specialisation... Although sole ownership does remove the incentive to shirk, the gains from specialisation are also forgone. (Barzel 1989, pp. 38-39)

Summing up, while a lack of specialisation suggests that the sole individual owner doesn’t use resources most efficiently, contracting between the owners of different inputs is costly. This is where a property rights understanding, which takes into account the costs and benefits of all arrangements (e.g. sole ownership and shared ownership), demonstrates its strength.

**Cooperative activity.** Contracting between the owners of labour and of capital needs to be commented upon. Three forms are possible: labour rents
capital; capital hires labour; or the sharing of income. (1) If the quality of capital doesn’t vary substantially, the owner of labour rents it for a fixed amount and takes responsibility for the variety of income stream that results from a variety of labour-inputs. For example, the profit may depend more on the skill of worker than on a variable quality of equipment. (2) In the second case, the quality of labour is uniform and the owner of equity capital takes responsibility for the variability and improvement of assets. The contract with labour input tends to take the form of a fixed wage contract. In both cases the principle is that the owner of the more variable input takes on responsibility. In both cases, parties to the contract accept incentives and self imposed restrictions. The owner of labour requires a fixed wage and accepts hierarchy. The owner of equity guarantees wages and captures excess income. (3) A sharing of income is possible as well. It depends on the nature of the particular business activity and on the variability of inputs (labour and capital) if the sharing of income is appropriate. For example, the income stream of an IT company depends on the quality of its employees but also on the quality of its equipment. Usually, it is more costly (it takes time) to assess the quality of employees, but there is the possibility that the choice between two competing kinds of equipment or the two competing kinds of software may be decisive for whether the endeavour would be efficient or not. The costs of monitoring shirking and the costs of investigation into the improvement of material resources persist. Property rights are better delineated (more efficiently) if the party to the contract that provides more variable input captures the larger share of income and assumes liability for any variability.

4.2 Collective ownership

Barzel (1989) provides two examples: a condominium and a taxi company. In the case of a condominium, the apartment owners decide about the management and use of a common swimming pool by voting. A purely commercial arrangement - which supposes the measurement and counting of who invested the most in the maintenance of the pool (cleaning and monitoring the use) so that the use of the pool would be allocated proportionally - might be too costly. In the case of a cab-company it is easy to measure some attributes of investment. Driver-owners allocate costs for fuel according to kilometres driven by each of them. The costs of new tyres might be allocated similarly. Since it is costly to measure and identify responsibility for the expenses of
fixing more serious damage it is usually taken as a collective liability; it is not allocated according to the use of assets. The parties involved in such a contract don’t allocate these costs proportionally to their use of assets but by the voting of members of a collective management body. If they don’t agree to establish the collective ownership of a resource the asset would not be utilised efficiently, or would not be used at all.

The principles that were advanced above apply completely to the processes of privatisation in Croatia and Slovenia. The capital that was earlier governed collectively was proportionately assigned to individuals; hence the benefits of capital were distributed proportionately. The costs of management of capital varied, as did the costs of the investigation of the attributes of resources and the costs of investigation of the market and contracting. Since perfect delineation of property rights is costly, an ideally proportional distribution of costs and benefits among individuals is hardly possible. It was indicated in the above quote from Barzel that the question which business organization is closer to the ideal of proportional distribution of investments and rewards couldn’t be answered a priori. The answer depends on the variability of attributes of assets and on the costs of their investigation.

4.3 The ownership structure of the firm

Alchian and Demsetz (1972/1999) analysed shirking as a standard problem of team production. Shirking was considered pervasive in self-managed companies in Croatia and Slovenia. Shirking is a consequence of the costs of monitoring variable inputs. Alchian and Demsetz concluded that a classical capitalist firm is the business organization that most successfully overcomes the problem of shirking. It unites the entire bundle of rights in the hands of one dominant team member, who is

1) to be the residual claimant 2) to observe input behaviour 3) to be the central party common to all contracts with inputs 4) to alter the membership of the team 5) to sell these rights, that define the ownership (or the employer) of the classical (capitalist, free enterprise) firm. The coalescing of these rights has arisen, our analysis asserts, because it resolves the shirking-information problem of team production better than the non-centralised contractual arrangement. (Alchian & Demsetz, 1999, p. 41)
Alcian and Demsetz (1999, p. 47) questioned whether dispersed shareholding represents ownership at all: “Instead of thinking of shareholders as joint owners we can think of them as investors, like bondholders.”

The problem of shirking in Croatia was emphasised to such a degree that companies were seen nobody’s property: as a solution in Croatia (and to some degree in Slovenia) majority ownership of capital was promoted; it was considered an objective of the process of privatisation.

The classical capitalist firm is a kind of sole ownership of a corporation. Nowadays, capitalism manifests an abundance of different ownership structures - joint stock companies, private companies, companies owned by families, partnerships, trusts - that serve their purposes more or less usefully. The success of a particular ownership structure depends on such things as the size of the company, the technology of production, the characteristics of assets, the characteristics of the market in which the firm has to win its competitive advantage and survive (Fama & Jansen 1983). Classical firms are expected to be efficient where agents’ behaviour is observable and financial capital investments are critical, while ‘employee owned’ ‘cooperative’ firms (partnerships, producers’ cooperatives) are expected where agents’ behaviour is very costly to monitor and human capital investments are critical (Grandori 2005).

In regard to privatisation in Croatia the questions are: did the promotion of centralised ownership favour the kind of production where human capital was not of particular significance; and did the promotion of centralised ownership aim to attract financial capital which was considered limited. It will be demonstrated that the decision makers in the process of privatisation offered to the owners of financial capital majority ownership in exchange for their economic and political cooperation. It was a kind of corruption; privatisation in the form of majority ownership regenerated in privatised form the old alliance between politicians and holders of economic power.

Privatisation encountered problems of organization of different inputs (labour, capital) in joint production and of choice between a centralised and decentralised ownership structure. David Miller (1981) demonstrated that producers’

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21 The inclination towards a controlling shareholder Demsetz (1983) confirmed when he concluded that “[t]he holder of corporate stock experiences a loss of control over his resources because ownership is so broadly dispersed across large numbers of shareholders that the typical shareholder cannot exercise real power to oversee managerial performance in modern corporations.”
cooperatives are not competitive with centralised capitalist firms under the condition of an unfettered market. Abstracting from the specifics of the assets and technology of production, Miller concludes that an unfettered market mechanism is not value neutral; it favours the “authority structure of the capitalist firm”. Unfettered markets and centralised firms promote particular public goods (moral norms); they are not capable of producing public goods of a different type. The description of the process of privatisation in Croatia and Slovenia will show what kind of public goods (moral norms, principles of justice) were assumed when different ownership structures were promoted. It was presented above that moral norms need not be cultivated at the expense of efficiency; they might stimulate it. The comparison of the effects of privatisation in Croatia and Slovenia is also a comparison of the implementation of distinct principles of justice.

4.4 The evolution of property regimes

Transition from socialism includes the transformation of the property rights regime. Libecap (1999/2002) has argued that a property regime defines access to and the use of resources; the nature of market exchange; and the working relationship within the firm. The pressure to transform an existing regime can emerge (a) from changes of relative prices, (b) from the changing of technology of production and (c) from a shift in preferences and other political parameters (Mahoney 2005). I will provide a few examples.

Harold Demsetz’s paper “Toward the Theory of Property Rights” tells a classic story about the Montagnes Indians that initiated a series of studies about the evolution of property regimes. When the demand for furs increased under French colonisation, the Montagnes divided their hunting territory and allocated it to individuals, it has until that time been used in common, in order to protect the resource from overuse. This is how the changing of relative prices may affect the transformation of a property regime.

The next example recounts that land in England was at the beginning owned by families. The technique of crop rotation influenced the fact that it became a system of property managed by the community – every year villagers allocated strips of land for grazing and for crop growing. The inventions of barbed wire and of selective breeding enabled the increase of efficiency of enclosure (Smith 2002). That is, technological invention initiated the transformation of family owned (private) property into property managed by the community. Re-privatisation was again a
consequence of technological change. As for a shift in preferences as a cause of the changing of a property regime, the emergence of national parks with the right to access open to the general public might be considered – at least to some degree – a consequence of the changing of people’s attitude towards nature. It is as if national parks express the understanding that nature must be protected by all, and that the enjoyment of nature must be open to all. However, it is worth noting that a simple change in preferences will not of itself have these effects; transactions costs may be so high that there is no feasible way in which changes to meet people’s preferences can take place, at least by means of voluntary transactions.

Demsetz hypothesized that new types of property regimes “emerge when the social benefits of establishing such rights exceed their social costs” (Merrill 2002). The question is how societies “calculate” the costs and benefits of regimes. The process of privatisation in Croatia and Slovenia was led by the idea of the economic superiority of the capitalist property regime to social ownership. As to the question of cost-benefit calculation, the answer was simple: the neighbouring capitalist countries were richer and this greater wealth was attributed to the advantages of their property regimes.

Nevertheless, it is not always possible to distinguish whether the changes of the property regime benefit an entire society or if a particular group is promoting its own interests (e.g. under the guise of doing things that are in the general interest). In the case of the Montagnes, it is not clear whether the allocation of hunting territory was beneficial only to an influential group inside the tribe. It has been concluded that for every transaction-costs explanation of the transformation of a property regime there was an interest-group explanation as well (Levmore 2002, p. 489). However, these two explanations are not mutually exclusive. Levmore provides an example of a tennis court that was public property, then common and then private property. Market conditions subsequently changed and the tennis court went back to being open to the public again. It was never distinguishable whether the changes were the product of the influence of interest groups, a benefit to the entire society or both. The impossibility of distinguishing between political and economic causes of the transformation of the property regime were confirmed – according to Levmore – in the particular cases of highways, intellectual property rights, and licensing regimes. Accordingly, since economic effects might drive political changes and vice versa, my description of the changes of property regimes in Slovenia and Croatia aims to include both the political and economic effects of privatisation.
“Technical issues” are not to be neglected. The transformation of the property regime is a problem of collective action. The old property rights were valued and their value should be taken into account in the allocation of new rights. Ostrom (2000) has found that more egalitarian societies, smaller and close-knit groups, more easily introduce mutually advantageous norms in new regimes because members trust one another. In other cases, a powerful oligarchy may drive the changes: “A wealth-enhancing transition between property systems sometimes requires some roughness in assigning and valuing rights if it is to occur at all. In a hierarchical political structure, that roughness will cause the gains and losses from the transition to be distributed unequally, in ways that favour the people managing the transition.” (Banner 2002)

Libecap (1999) identified the factors that influence the success of transition from an old to a new institutional structure.

- The larger the expected aggregate gains, the more likely some agreement will take place.
- If the heterogeneity of bargaining parties is large and their number is bigger, it makes transition more difficult.
- In the case of unbridgeable differences between parties, side payments to potential losers might ease transition efforts.
- Transition is easier in the case of a large dispersion of wealth. The expectation of high social mobility under the new regime is favourable for smooth transition.
- The characteristics of assets to be allocated might make calculation of share values difficult for the negotiations and the enforcement of property rights.

The insights and conclusion that have been indicated above I will use to describe the evolution of property regimes in Croatia and Slovenia. It is immediately worth noting that it seems that Slovenia fits to the case of a close-knit community, while in Croatia, a powerful oligarchy forced the changes.

5. Concluding remarks

The purpose of Chapters II and III was to outline a theoretical framework for the following description of privatisation in Croatia and Slovenia. Chapter II analysed controversies about the traditional concept of property and how it
relates to the ideas advanced during the period of transition from socialism. The program of transition that relies on the neoclassical concept of property and market was presented. It includes unified ownership, an arbitrary distinction between private and public property and a view of the market, which reduces it to a pricing mechanism. Chapter III introduces the basic concepts of property rights economics, and a view of the market that is hospitable the new understanding of property; the distinction between individual and collective property and factors that affect the evolution of property regimes are explained.

The following chapters will serve to explain that privatisation in Croatia was undertaken as if it was the creation of a property regime de novo. This well fits the rhetoric that social ownership was actually no ownership at all, that the distinction between socialism and capitalism is unbridgeable, and that only concentrated majority ownership is an adequate ownership structure. Privatisation in Slovenia looks like an example of the evolution of an inherited property regime. Particular attention will be devoted to the development of financial systems in Slovenia and Croatia; especially to the question of how to create a financial market to promote the public good.

Following the insights that were presented above, I shall investigate who were the winners and losers in the transition, whether collective action was characterised by "some roughness" or by mutual trust and what were the economic benefits and costs of the transformation of the property regimes. My research indicates that transition in Croatia was pushed by a powerful oligarchy, due to the heterogeneity of preferences among social groups, while the Slovenian transition was closer to the case of close-knit societies. In both countries, side payments were offered to the workers and other groups of citizens, distributing to them shares free of charge or at a great discount. However, key conflicts occurred with respect to expectations about the future property regime and over the calculation of the value of assets to be allocated and of the rights of incumbent owners.
Chapter IV

Self-Management and Social Ownership

Chapter IV and chapter V are closely related; in chapter IV the unique property regime of self-management and social ownership, which was the system prior to privatisation, is described, while in chapter V the debate concerning how to reform this institutional framework and how to privatise the assets that were managed and controlled collectively is presented and commented on. The analysis relies on the insights that were developed by the theory of property and presented in chapters II and III. Before the description of self-management and social ownership I will briefly say a little more about the two understandings of property.

The traditional understanding of property and the alternative one which was developed within the framework of the economics of property rights are not necessarily in conflict. Traditionally, property is understood as the relationship between a person and a thing and the relationship between persons in regard to a thing. Roman law defined property as the right to manage, use, and alienate a resource, while the duty not to walk across somebody’s land represents an example of the relationship between persons in regard to thing. It is not always easy to conceive the distinction between this concept of property and the alternative one. A simple definition that property rights of individuals over assets consist of the powers to consume, obtain income from, and alienate these assets (Barzel 1989, p. 2), doesn’t reveal much. Additionally, the concept of property within the economics of property rights is not developed into a systematic and comprehensive theory; rather it contains a number of important insights.

An illustration could be the analysis of initial appropriation. The economics of property rights is not initially concerned with the justice of appropriation: whether the resource should be allocated to the people in need or following the principle of desert or according to the principle ‘first come first served’. However, if initial appropriation is organised as a rush for resources, the analysis demonstrates that it leads to their dissipation (chapter II); an alternative form of appropriation might overcome or mitigate this problem. Since this alternative form can respect the
principle of justice, customs or attributes of assets it implies that the economics of property rights doesn’t neglect but emphasises tradition, moral issues, beliefs and dominant theoretical expectations in regard to property.\(^1\)

The distinction between the two approaches in regard to the market is similar. Neoclassical economics assumes an idealised market, which – if not restricted – allocates privately owned resources to the place of their most efficient use; a mathematical model of such a result is provided. The distinction between public (centralised) and private (decentralised) property is advanced. Private property gives property owners the rewards of their labour on what is ‘theirs’, and thus a property regime encourages them to take care of their property – to invest their time, effort, and talents on it – or to sell the property to someone who can make even better use of it. In such a model of a market, “when all this investment and buying and selling reaches equilibrium, the end result of a private property system is the biggest possible pie.” (Rose 1987)

Within the framework of the economics of property rights “all methods of allocating resources have costs and benefits and no single mechanism works for free and dominates all others.” (Allen 1999, p. 895). The collective use of a particular resource that is owned by an individual could be more efficient; it depends on attributes of assets that should be investigated, on the costs of the protection of assets and of negotiation, and so on. There are also costs to the transition from the existing to another system. Again, the organization of an efficient market and efficient use of resources depends on the initial allocation of property and on the inherited social and political structure, institutions, customs, and beliefs. Neoclassical economics sees the growth of a market economy as the removal of obstacles to an abstract ideal market exchange subsequently to an initial allocation of resources to private owners. On the other hand, the economics of property rights compares and analyses various paths of institutional change and of a transformation of the property regime. Accordingly, the reform of self-management and social ownership may take two paths: (1) assets should be allocated to individuals who autonomously develop the system of free exchange of the distributed assets; (2) an evolutionary approach to the reform of self management and social ownership assumes the allocation of property rights (not assets) and the development of an adequate institutional framework of exchange of these rights in such a way that the resource wouldn’t be wasted but improved;

\(^1\)Alternatively, this can be formulated as which type of justice is more economically efficient, or what are the economic consequences of alternative types of justice, different customs and so on.
the existing allocation of rights, the inherited principles of exchange, customs, and expectations are taken into account.

1.1. Communal ownership of a workers’ cooperative

Self-management and social ownership weren’t only an ownership structure of a particular business organization, of a company or a firm; they were also a property regime that combined the characteristics of workers’ cooperatives (self-management component) and communal ownership (social ownership component). It is important to note that there was a complex relationship between the public and private sphere. In the following sections I will describe it, and then will discuss: how the bundle of rights was broken-up and re-allocated; how the controlling role of the state was exercised; what the liberties and duties of individuals and other input owners (banks) were; and how the market was regulated. The origins of this unique property regime, why it emerged at all, and its costs will be presented. Then I will comment on various theoretical analyses of workers’ cooperatives.

The history of self-management and social ownership is instructive. The first decades of its development were economically extremely successful; the self-management economy was among the most successful in the world. I will explain what were the causes of the harsh deterioration and long stagnation that came later in the last ten to fifteen years of socialism. I will briefly present the history of the decentralisation of economic decision-making and then the growth of a managerial class when industry was developed towards production requiring more knowledge and management skills. The transformation of the legal property rights regime didn’t adequately follow these changes. Then I will describe the development of the banking system, the ideological constraints under which it operated and its heavy regulation. In my opinion the extremely high costs of allocation of capital, which were also related to the ownership structure of the firm, were the key problem of the property regime of self-management and social ownership.

1.2 The myth of self-management

Chapter IV is less a critical analysis of self-management and social ownership than an investigation of its legacy, which substantially affected the process of privatisation. This is why some ideas, which are closely related to the ideology
of socialism, are not analysed and commented on in detail. Property regimes are accompanied by their distinct economic cultures that regulate trade and the distribution of income and create expectations about future activities. Self-management, over the forty years of its life, developed its own political system, its own ideology, mythology, and even its own interpretation of history. For Croatian philosophers based around the journal *Praxis*, self-management was considered a possible economic implementation of their unique concept of the creative and self-creating personality. In the debate on economic transition in Croatia, the old guard of public intellectuals accentuated the themes – which derived from this heritage - of equality, participation, cooperation and loyalty (Katunaric 2004). While the younger sociologist Stulhofer (1999) viewed that kind of socio-cultural legacy as an obstacle for the development of capitalism, of individual incentive and competitiveness, the older scholar Katunaric argued that past experience should have been respected more during the reforms.

That memory, it will be seen later, was decisive in influencing people’s attitudes towards privatisation, and for the assessment of the results of this process. Though support for private property over social ownership was increasing among the Croatian population during the 1980s while the economy stagnated and in the first half of the 1990’s (Kristofic 1999), in 2006 more than sixty percent of Croatians had a positive attitude towards self-management.³ These results were certainly influenced by the negative public attitude towards the period of post-Socialism, especially toward the practice of privatisation in Croatia.⁴

It should not be neglected that this unique property rights regime of former socialist Yugoslavia attracted great interest abroad; it was intensively analysed by international scholars (Vanek 1970; Vanek 1972; Estrin 1983). The experiment with self-management stimulated Benjamin Ward (1958) to compare the efficiency of the producers’ cooperative with that of the classical capitalist firm. The study of self-management and social ownership also made an important

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² The surveys conducted in 1989 and 1996 recorded 55 percent and 58 percent of people who favoured private property over social ownership respectively.

³ In April 2006, the Hendal Market Research Company conducted a survey of a selection of the Croatian population with the question: *Do you have a positive or a negative view of self-management?* Along with the sympathy shown by older people, who may feel nostalgia for their youth, in the group of respondents between the ages of 18 and 24 years more than 50 percent expressed a positive attitude towards self-management.

⁴ According to research conducted by the Ivo Pilar Institute in 1998, only 1 percent of the Croatian population were satisfied with privatization and 47 percent of those surveyed were entirely dissatisfied (Cengic & Rogic 1999)
contribution to the development of the economics of property rights (Pejovich 1966; Furubotn 1971; Furubotn & Pejovich 1973, 1974; Furubotn 1976). As for the theory of the firm, Alchian and Demsetz (1972) in their seminal paper “Production, Information Costs, and Economic Organization”, devoted a section to the firm in Yugoslavia. The theory of transaction costs was employed for the analysis of socialist conglomerates (Sacks 1983). Self-management and social ownership were considered to be important examples of industrial democracy (IDE 1981), and of participatory and labour managed firms (Jones and Svejnar 1982). Scrutiny was devoted to non-pecuniary gains from the system: workers’ satisfaction, employment security, and collective consumption. It seems that the myth of self-management somehow survived what I would take to be its inevitable disappearance. Difficulties of the transition in Eastern Europe and the countries of the former Soviet Union stimulated Joseph Stiglitz (1999) to recall the positive sides of self-management.\(^5\) In this chapter I will present some findings from these studies.

2.1 The basic concept and key controversy

Throughout the four decades of its existence (1950 – 1991) social ownership and self-management were reformed repeatedly, sometimes substantially, but the basic idea remained unchanged. The workers in a company elect a workers’ council from among their own members, which nominates and confirms the executive director, or the members of the executive body, and all of them together, the workers and directors, run the company. The company can itself choose output policy and set prices, it autonomously makes contracts for the sale of its outputs and the purchase of its raw materials (Ward 1958, p. 567). This is basically the self-management component of the arrangement.

As for the social ownership component, it was described (Horvat 1993) that the collective borrows its entire capital stock from society, which remains the collective owner. Over time society was represented by different local, regional and national public bodies. Most often these public bodies included representatives of the Communist Party, unions, war veterans, youth organizations and so on, but the

\(^5\) “The leasehold firm, like the TVEs in China, or the self managed firms in Yugoslavia, were far from perfect by Western standards. A large literature had detailed both the strengths and weaknesses of the Yugoslavian model, and suggested reforms that would improve their performance. A priori, one would have thought that the chances of improving upon the flawed decentralized ownership forms were at least as good as the chances of designing new privatization schemes, de novo.” (Stiglitz 1999)
influence of the Party was decisive. The responsibilities of the public bodies were changing continuously as well; sometimes they only endorsed the election of the president of the management board but sometimes they affected the allocation of profit. It was explained that in this system “labour hires capital rather than capital hiring labour or an entrepreneur hiring both fact ors” (Estrin 1983, p. 12). In the early stages the working collectives (enterprises) paid for the use of social assets; this was abolished at the beginning of the Seventies. Given that this payment was transferred into the public funds it in fact represented only a form of taxation.

Society protected its assets by formal rules. Companies were ordered to subtract (before distributing wages) a few percent of their income for obligatory savings and investment into the business fund to preserve the value of their capital. The business fund is in fact a separate account which the firm could use only for investment in capital. The idea was to restrict consumption and stimulate investment. It was controlled whether a percentage of income was allocated to the fund, but the choice among business options was left to the firm. Hence, companies were forced by formal rules to invest in the existing enterprise or in new plants and new activities. The law guaranteed a minimum level of wages. The banking system was an additional source of short-term and long-term financing for companies’ activities. A framework for the use of financial and natural resources was prescribed, and if a collective failed to achieve what it was supposed to accomplish then the community (the above described public body) replaced the management or placed the resources with another collective. The key fact was that socially owned property, “may not be sold since it belongs to society as a whole” (Grapinski at al 1989, p. 33). Therefore, the placement of capital into the most productive use was restricted. Ward (1958, p. 568) summed all of this up by saying that under this system, then, costs would be the sum of material costs, “regular contributions” to the state (interest charge on fixed capital, ground rent, excise tax on sales…), the wage fund and interest on outstanding loans. If a firm were no longer able to pay duties to the state and to pay wages it would become bankrupt. Revenue less costs, i.e. profit, became the measure of success of the firm. Generally speaking, profit belonged to the firm, though the community very often powerfully affected its placement.

It was rarely decided that firms in financial difficulty had to go bankrupt. Usually it was decided, after consultation with the unions, the Communist Party and the local assembly that the company would be bailed out by the government or by other companies with the support of the Government. The old management was usually
replaced and if banks or other companies invested in the rescuing of the company they got interest on their investment.\(^6\) The influence of investors on the company in which they invested wasn’t direct but it was mediated through the public body. In the process of the election of management bodies (workers councils), voting rights were usually distributed according to the principle one employee - one vote. In the case of a labour managed firm (LMF) in capitalism, the voting rights depend on the amount of shares in the ownership held by an employee (Uvalić 1992).\(^7\)

A company’s legal duties and obligations toward society were frequently changed over the forty years of existence of social ownership. These changes to a large extent influenced the behaviour of the firm, executives and employees and shaped ownership rights. There were two opposing explanations for the constant regulatory reforms. According to the first understanding it was a consequence of the fact that the basic structure of self-management wasn’t viable without strong regulatory support (Furubotn & Pejovich 1973, 1974; Grapinski et al 1989). On the other side, the advocates of self-management claimed that the ruling communist ideology wasn’t capable of accepting the autonomy of companies, producers and the market (Horvat 1982; Uvalić 1992). The relationship between regulatory constraints and ownership rights, between the public and private sphere, i.e. between the state and companies deserves a brief comment.

### 2.2 For and against self-management

Furubotn concludes that there was “an inherent flaw in the structure of the pure labour managed firm” (Furubotn, 1974, page 274). This flaw was found in the structure of property rights that were limited as to the pure use of capital while the transfer of capital was restricted, though collectives were granted substantial freedom in decision-making. Therefore, “a collective may choose to pursue policies that are not consistent with efficient allocation of the nation’s resources or with community welfare” (Furubotn & Pejovich 1973). According to Furubotn (1974, p. 276) “[t]he central authorities are forced to use both direct and indirect means in the attempt to guide the behaviour of the firm and induce it to act in ‘socially approved’ ways” (my emphasis). In my interpretation, Furubotn implies that

\(^6\) For a detailed account of number of bankruptcies and acquisitions of loss making firms see Uvalic (1992, pp. 106 – 111)

\(^7\) It is possible to have labour managed firms under capitalism. Shares are distributed among workers and sometimes among former workers (pensioners). The most important restriction is that a worker who leaves the company must sell his share on the company’s internal market, or at least selling to outside investors is forbidden.
workers’ collectives necessarily overuse resources if regulatory constraints don’t force them to use the nation’s resources in socially approved ways (because of the restricted transferability of capital). In my opinion this kind of general criticism is not correct. It doesn’t take into account the relationship between the ownership structure and attributes of assets. There have been examples of viable communal ownership and also various forms of employees’ cooperatives (partnerships for example) where transferability of capital is restricted.

It is explained in chapter III that transferability is always somehow regulated, formally or informally. If the ownership structure is not adequate for business activity then transferability of property might be a solution. However, it requires an efficient market for property rights. I am not trying to defend self-management from all criticism, but only from this type of general criticism that finds an inherent flaw in such a structure: though the number of cases in which self-management was efficient might be very small, there is no structure of property rights which is efficient for every type of resource and for every business activity. Also, it is to be noted that one may interpret Furubotn as if he legitimised the intervention of public bodies into business decisions. Consequently, the above-explained undifferentiated view of self-management opened the possibility for a conclusion that opposes Furubotn’s intentions.

On the other hand, the advocates of self-management didn’t see that this ownership structure wasn’t universally efficient. Their criticism of the system was in fact “liberal” since they were focused on the bureaucratic nature of the socialist state. In the end they concluded that self-management was always suppressed by the state and was perhaps never given a real chance. Furubotn concludes that the allocation of resources was distorted as a consequence of the ownership structure (workers’ cooperative); the defenders of self-management agree with the assessment of inefficiency, but they ascribed it to the general features of socialist economies (state interventionism, egalitarianism) rather than to self-management (Uvalic 1992, pp. 213 –215). The proponents of self-management

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8 “In the fourteen years covered (1952 – 65), every three days brought a regulation issued at the level of the Administration or Parliament. In addition, the Federal economic secretariats and banks produced rules, orders, instructions, decisions, and solutions (245 in 1965). When we take into account the regulations of the republics and localities, and subtract holidays and vacations from the time available, it follows that every working day brought some administrative surprises. However, this does not exhaust all the possibilities for administrative pressure. State bodies, the National Bank, and the Social Accounting Service also have their internal regulations; they also change and, by the nature of things, even faster and more often than legislative acts.” (Horvat 1971; here quoted from Moore 1980, p. 5)
concluded that the transfer of social capital to be managed by workers in fact signifies fulfilment of socialist values and that there is no necessity for further substantial state intervention. In their opinion, this distinguishes the system of self-management from a rigid communism, which tended to control the economy from the top. Since they didn’t see that self-management wouldn’t be an adequate ownership structure for all business activities, they were reluctant to introduce a more flexible market for property rights. This will be presented in chapter V, which describes the privatisation debate.

The development of the relationship between the private and public spheres under socialism, which was briefly commented on above, and during the transition to capitalism will also be analysed in the following chapters. Further description will hopefully elucidate the problem that was crucial for the development of self-management and social ownership, and for the design of privatisation in Croatia and Slovenia. Actually, the question was whether the self managed company was already private (or to what degree it was already private) and – consequently – should the company autonomously decide about the transformation of ownership. This will be analysed in Chapter V. Now I will provide more empirical and historical details about the development of self-management.

### 2.3 The beginning of self-management

The system of self-management was formally introduced in June 19509, at the start of the end of the period of central planning, which was an official economic policy of the communist regime in the years of post-war reconstruction. The decision followed the conflict between the Communist Party of Yugoslavia (CPY) and the International Communist Movement headed by Stalin, the leader of the Soviet Union. In opposition to the system of central planning, self-management was presented as a proper implementation of Marx’s idea of an association of producers.

Immediately after the War, all mineral wealth, power resources, means of communication, large companies, factories, banks, and almost everything except small craft workshops, shops and small agricultural households, were nationalised mainly without compensation (Singleton and Carter 1982, pp. 99-117). The production of everything, from coal to shoes, was directed by the central planning...
body, the Federal Planning Commission, which was responsible directly to the federal government (Horvat 1976, p. 7). Hence, almost the entire bundle of property rights was controlled by the state. The fact is that five years of central planning in Yugoslavia confirmed the theoretical assumption that it was almost impossible for central planning to be economically efficient.¹⁰

I identify three instances important for the emergence of self-management: (1) tradition, (2) economic motivation and (3) political circumstances.

(1) Resistance to crude communist practice was strong, especially among agricultural households in the wealthier federal units of Slovenia and Croatia, which insisted on their economic autonomy (self-sustenance).¹¹ Croatian and Slovenian pre-WWII peasant cooperatives bore some resemblance to Western European farmers’ cooperatives (Singleton and Carter, 1982, p. 109). For many scholars (Grapinski et al 1989, p. 237) the idea of self-management also resembles the notion of common property in resources, an archaic form of joint-ownership associated with the rights of families, kin-groups or villages (and which was found in Germany and surrounding countries). In that sense, the introduction of self-management was a continuation of the traditional property regime.

(2) It was a period of industrialization and urbanization. The new industrial workers, who had just come from their villages and didn’t have any possessions, recognized in the idea of self-management some similarities to the system of common property from their own countryside. The institution of workers’ councils possibly reminded them of agricultural cooperation (common ownership of resources and means of production – tractors were bought by a cooperative; the members of the cooperative had an equal right to use them regardless of personal wealth), with which they were also familiar. Above all, it offered them some kind of respect and equality. The attempt to improve the coordination of economic activities (in comparison with central planning) was also one of the motives for the decentralisation of management rights and of responsibilities for economic performance.

¹⁰ “In Slovenia, a village which produced no wheat was ordered to deliver its quota of grain; other villages which produced wheat but no surplus fruit were ordered to deliver fruit...” Sometimes, not even seed for the next year’s harvest was left to the peasant. “Smart” officials falsified records. “Penalties for non-delivery could involve confiscation of land.” (Singleton and Carter 1982, p. 107)

¹¹ Before World War II, 75 percent of the population of Yugoslavia lived from agriculture and a few years after the war that percentage was more or less the same (Singleton and Carter 1982, p. 105)
The conflict with orthodox communism was certainly important for the emergence of self-management. Trying to distinguish itself from Soviet practice, the CPY declared the separation of the State from the Party, which retained the role of the leading ideological force.\textsuperscript{12} (It must be said that the influence of the Party remained decisive for the entire period of socialism.) It was expected that a new legitimacy for the political authorities would be provided by the decentralisation of the risks and responsibilities of economic activities and by the promotion of new ideological principles: “factories to the workers” and “land to those who cultivate it”. The next section about the responsibilities of directors and working councils explains how it was implemented in reality, and which property rights were transferred and to whom.

\section*{2.4 Directors and working councils}

The responsibilities that were transferred from the central government to companies are explained in Ward’s (1958, p. 567) description of “the new planning system”: “[The central] plan no longer prescribed output norms for firms and industries. Figures in the central plan represented generalized expectations rather than explicit norms... Prices had gradually been released from central control until here too the firm had the right to price its own products ‘on the basis of market conditions.’” The next question is who in the company took over these rights.

Passing of Legislation in 1950 didn’t, in the beginning, change much in the governance of companies. According to the Law\textsuperscript{13}, companies should be managed by working collectives on behalf of the social community, within the framework of the economic plan of the State. The wide competence of a director, nominated by the “local community”, was retained. The director had the power to make binding contracts, to hire and fire workers, and to enforce daily discipline. The director had to consult the working councils only for strategic decisions. The ideology of workers’ rights had not yet been developed.

With further development, in line with the nuances of ideological changes, the position and responsibilities of the management body, executive directors and workers’ councils were changed as well. During the next few decades, the procedure of the election of management was changed several times. “Until 1965 and again

\textsuperscript{12} The Party renamed itself for the League of Communists. For detailed account about the ideological evolution see Likić Brborić (2003)

\textsuperscript{13} The Law on the Management of Government Business Enterprises and Economic Associations by Workers’ Collectives that introduced self-management
after 1974, the commune [represented in the above described public body, section 2.1] had significant power in the selection process, by virtue of membership on the committee\textsuperscript{14} that either selected the director, until 1965, or compiled the list from which the director was chosen by the enterprise (after 1974)” (Moore 1980, p. 8).

For the purpose of easier understanding, I would like to add that the development of self-management was usually divided into two periods. From the beginning of self-management in 1950 the economy was gradually liberated. After 1965 brave pro-market oriented reforms were undertaken (section 2.5 Towards “market socialism” below). This produced strong macroeconomic imbalances: inflation and unemployment started rising. As a reaction to these problems an anti-liberal and against the market the Agreement Economy was introduced into the Constitution of 1974 (section 4.3).

\textbf{2.5 Towards “market socialism”}

In the first decade of self-management Yugoslav economic growth was among the strongest in the world, with levels of around 10 percent.\textsuperscript{15} Though later analyses assigned it to various influences, for example to international financial support being given to a socialist country that was not a member of the Warsaw Pact, Yugoslav communists started to believe that they had found the magic formula to reconcile economic efficiency and the proclaimed ideal society of general equality. Full of enthusiasm, the communists of Yugoslavia released at the 1958 Party Congress (convention) their new Program. They promoted further changes of the same nature as the introduction of self-management, which was understood as a decentralisation of decision-making in business. The changes were synthesised in four D’s: democratisation, decentralization, depoliticization, and deetatization. As for democratisation, Yugoslavia under socialism had never held competitive multiparty elections and the freedom of the press and the freedom of citizens to form associations were restrained (however never so strongly as in the countries of the Soviet bloc). Therefore, a program of democratisation was reduced to the

\textsuperscript{14} The committee is the League of Communists organizational body, which was the most influential member of the Community Assembly, together with unions, the organization of youth, war veterans and other representatives and this structure formed what was called “democratic pluralism”.

\textsuperscript{15} There are disagreements on economic growth, due to the different statistics. But, all authors, Horvat, Moore, Singleton and Carter, Uvalic, Gapinski et al agree that economic growth during the 1950’s was very close to 10 percent per year
decentralisation of decision-making, which in part really occurred. Though the level of economic decision-making was lowered, the idea of the autonomy of enterprises and their depolitization was never completely fulfilled.

The distribution of personal income inside the company and at the level of the country was undertaken under strong pressure from egalitarianism. Minimum wages were regulated but also the ratio between the highest and lowest salary within the company and even within each industry. Less profitable companies suffered difficulties in paying their workers on this basis while very profitable companies usually extensively invested in housing for their workers and granted them non-pecuniary benefits.

In the first few years of the Sixties “more than half of national income ... generated in industry and mining was taxed away from the enterprises.” It was used for general government expenditure but also for investment in infrastructure. Moore observes that “possibly the most important provision of the 1965 reform was its reduction of taxes, which increased the discretionary authority of enterprises” (Moore, 1980, p. 9). Namely, pressure on companies during the Sixties was gradually reduced and Yugoslavia had entered something that was, later, often called “market socialism”.

When price control was removed, “prices rose by an average of 30 percent. The highest increases were in food, electricity, transport and rents” (Singleton and Carter 1982, p. 137). When control over distribution of personal income was relaxed “wages surged far ahead of productivity” (Horvat 1976, p. 21). Along with these changes the level of unemployment soared. The borders were opened for the unemployed and for others to leave the country, to find a job in Germany, France... and even in Australia. Today, it seems easy to conclude that Yugoslavia and Yugoslavian socialism weren’t capable of withstanding market deregulation.

3.1 Theoretical analyses

The question of the relationship between self-management and the market requires presenting the most important findings of intensive theoretical investigations which have taken place concerning the system of social ownership. Ward conducted an initial comparison of the classical capitalist firm and the workers’ cooperative. The initial assumption was that the classical capitalist firm is profit maximizing, while the workers’ cooperative maximizes the revenues of employees. In Ward’s
model the entire profit was distributed as a wage bonus (zero-profit condition), and every employee received an equal amount. According to Ward’s (1958, p. 577 and p. 583) analysis the workers’ cooperative “is capable of producing in the short run at a level equal to or even greater than that of its capitalist counterpart”.

Ward concluded that under the conditions of an imperfect market, of an increase in demand and rising prices, the producers’ cooperative tends to lower output. Vanek (1970) had found that particular regulatory conditions (lump sum taxes, fixed capital) enable the overcoming of this unwanted outcome and argued that in the case of an imperfect market the capitalist firm also requires regulatory intervention to achieve an optimal allocation of resources (Steinher 1976, p. 339). Vanek strongly claimed that, under conditions of competition, self-management would lead to an optimal allocation of resources as would the capitalist firm. However, the dynamic of a competitive market remained a concern for the system of self-management and social ownership.

The Ward-Vanek model abstracts from particular important issues. Ward didn’t discuss under what conditions workers, the state or a group of individuals would be motivated to invest in new production. He also noted:

- The absence of a capital market (there was “no evidence that ... authorities varied [the] interest rate on existing capital”);
- The different positions of the director and the employees regarding wage maximization (“in a large number of firms policy decisions are made by the director without much reference to the wage-maximizing desires of the workers”)
- A large number of restrictions on competitive imports. (Ward 1958, pp. 583-584)

Further research was mainly oriented toward the identification of what kind of market and economy were developed under the system of self-management and social ownership. The following points attracted the most concern: the complex system of property rights over capital; the role of the banking system; the characteristics of the labour market and the divergence of interest between management and workers.

Furubotn and Pejovic (1973, 1974) approached the problem from the position of the economics of property rights, which was at that time in the early stage of
development. Furubotn and Pejovich concluded: Since employees were collective owners of the firm, they had two wealth-increasing alternatives; the first was joint investment in assets of the firm via retained earnings; the second option was distribution of earnings in wages and then investment of money in savings deposits or other assets. According to the Furuboth and Pejovich analysis, for the majority of workers, joint investment could be satisfactory only from a long-term perspective (up to 20 years). Hence, there is a tendency toward investment in individual assets, an increase of consumption, and the bank loan becomes a dominant source of investment in the company. The responsibility for investment had shifted from the working collectives to banks. The development of the banking system under self-management will be described below.

The initial structure of property rights (and additional regulation) also influenced the labour market. The initial majority of workers aren’t properly motivated to invest and employ additional workers. Therefore the community (the owner of capital) usually imposed a regulatory duty that forced collectives to invest and employ additional workers. The proponents of self-management challenged this conclusion. They insisted that without regulatory duty the self-managed companies would invest under pressure of market competition. However, they didn’t provide a persuasive proof (model) that it would happen for sure. Nevertheless, there was empirical evidence of such behaviour of labour managed firms; in Slovenia during the transition from socialism a number of workers’ cooperatives that encountered the crisis of demand collectively agreed to deduct from their wages and invest in improving productivity. It was an important feature of the Slovenian privatisation (chapter VIII).

Collectives were also forced to invest a share of their earnings in “collective consumption”: e.g. a local sports stadium or library or in houses for employees. Since workers tended to be tied to the firm in which they had invested “non-pecuniary income”, and resisted the hiring of additional workers, the effect of collective consumption was to limit the mobility of labor (Furubotn 1971, 1976). On the other hand, the advocates of the labour managed firm (Dubravcic 1970) saw its advantage in the fact that workers as owners are not interested only in the end result (like capitalists in a profit maximizing firm) but also in the conditions of the production processes (non-economic interest). From the point of economic efficiency “non-pecuniary income” was probably a waste of resources but the positive memory of it represents an important legacy of self-management.
4.1 The emergence of the management class

Furubotn (1976) also analyzed the differences between the preferences of decision makers (directors) and the preferences of the workers. Since economic development increased the demand for skilled workers and influenced the rise of a management class it induced a conflict of preferences between white and blue collar workers; while blue collar workers adhered to egalitarianism, skilled workers requested the distribution of income according to merit. This conflict appeared to be a key point for understanding the destiny of self-management. Some Party members established in time their positions in the executive class, substituting membership of the management body of one firm for another from term to term. Furubotn (1976, p. 104) concludes: “The worker-voters who actually determine the firm’s behaviour are not concerned with the position of labour in general but with their own welfare.” As a consequence, in Furbotn’s analysis, the labour managed firm is not inherently an efficient economic organization: “Policies that increase the wealth of the firm over some stretch of time, but don’t improve the appropriable real incomes of the decision makers, during this same period, are not likely to be considered desirable, and will tend to be rejected... Whatever its contribution to industrial democracy, it [LMF] is not an inherently efficient economic organization” (p. 122). If the economy was developing, under pressure from international competition or through slow internally motivated improvements of productivity, the regime of property rights, which favoured egalitarianism in decision making, was under pressure to accommodate itself.

In the beginning, when self-management was introduced, 90 percent of companies employed less than 30 workers. Self-management was a form of direct industrial democracy. In time, however, with industrial growth, things changed. The management became more influenced by a political class than it was under the influence of workers. As a result of political pressures, self-managed firms invested extensively, while the pressure from the workers was to increase their income. The management, usually, fulfilled both goals. Banks were therefore seen to be there to satisfy companies’ appetite for money. (The development of the banking system will be explained in the next section.)

16 The debate about the principles of the distribution of income was one of the most intensive discussions of the late years of self-management (Kardelj 1976)

17 This is why some claim that the self-management firms were never true representatives of a pure theoretical model of labour managed firms (Gapinski et al 1989, p. 11)
As a consequence of a combination of politically guided investments and workers’ pressure for an increase of consumption, inflation and periodical devaluation of the currency were common, especially in the last decade of socialism, when investments were no longer as profitable as they had been earlier, in the “period of recovery” (that is, the Fifties) and in the period when infrastructure investments were undertaken during the Sixties.\(^{18}\) It should be said that in the Sixties the class of so-called technocrats was formed especially in Slovenia and Croatia, and among them the idea was born that workers’ ownership should be formalised. Stane Kavcic (whom the Party expelled and degraded at the beginning of the seventies), had proposed the introduction of employees’ shareholding as a replacement for collective workers’ ownership. Technical aspects of the idea were not developed in detail. The possibility for employees to invest in shares was proposed but also the possibility of issuing bonds and investment in social funds was proposed. Since the idea came from managerial and financial circles outside and within the Party, communists at the federal level of Yugoslavia harshly rejected this proposal for ideological reasons, assessing it as the expression of a managerial tendency to form an alienated managerial “group ownership”. (I will provide more details at the beginning of chapter V). Later, in the process of privatisation, this process of the emergence of a management class and concentration of ownership rights became unavoidable.

### 4.2 Banking under socialism

Contrary to the usual assumption, socialist society in Croatia was dynamic; changes and attempts at improving the organisation of society were continual; the same was the case with politics, economic relations and the banking industry. At the beginning period of central planning money and banks had a very limited role. The subsequent reforms reflected ideological and political changes, but also expressed an understanding of how to activate resources and how to combine them for satisfactory production. The following short historical overview shows the process of decentralisation of particular property rights which were, like everything else, under the control of the state from the beginning of communist rule.

After WWII Croatia, as a part of Yugoslavia, had accepted a banking system of the Soviet type (the so called mono-bank system), which corresponded to a

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\(^{18}\) Janos Kornai (1984) developed the theory according to which overinvestment and soft budget constraints are common for the behaviour of the socialist firm. Uvalic (1992) tested and confirmed that theory for the self-managed firm in Yugoslavia.
centrally planned economy. There was only one bank with branches around the country. Production quotas were ordered by the organ of planning, and prices and wages were fixed. Money was a unit of account and a means of payment. Private households and individual producers were not permitted to have bank accounts, while “public persons” were not allowed to hold currency – they were obliged to deposit all currency received in dealing with the private sector into a bank account. Self-management cannot work in the environment of a mono-bank system. The rights of a company to set prices and freely distribute income don’t bring much practical value if individuals don’t have bank accounts.

The mono-bank system was gradually abolished in the 1950s: former branches of the Central Bank became communal banks having the right to accept short time deposits from enterprises and households, and to provide short-term commercial loans (for example a loan for the procurement of coal for the winter season). Banks were authorized to conduct a limited number of simple operations. Larger investments were the responsibility of state funds (Babic et al 1999). Money management in companies was strictly regulated. Enterprises were obliged to run different accounts for different expenditure purposes: a company might have money to pay suppliers but not the right to use it for this purpose because it was in the account for wages. Liquidity management wasn’t autonomous. In other words, property rights in the management of a firm’s income were limited. The financial system was stiff and firmly controlled.

Slowly, by way of several successive reforms, the management of banks was decentralised, and the number of financial instruments was increased. The savings rate of self-managed companies was very high, and the rate of investment even higher (Uvalic 1992, p. 69), but this was mainly a consequence of compulsory savings and investment, ordered by strict regulation. Additionally, the Party’s officials constantly criticised companies for the low rate of voluntary savings, attempting by that means to stimulate economic growth. The allocation of investments wasn’t efficient. Bajt has found that, “had the efficiency of the Yugoslav investment during 1950-80 been similar to that of comparable capitalist countries, the gross social product in 1980 would have been twice as high as it actually was” (Bajt 1993/2001, p. 39).

Interest rates were fixed, and there was no adjustment for inflation. The maximum returns from investment in savings deposits were negative in real terms. “Such an interest rate policy was a cause of significant redistribution from households (as
net lenders) to enterprises (as net borrowers)” (Uvalic 1992, p. 98). Hence, the regulation of the banking sector deformed the tendency that was identified by Furubotn and Pejovich that workers prefer distribution of net income in individual assets over joint investment.

In the 1970s the legislature opened the possibility for any group of companies and other public persons (local communities, associations, but not private individuals) to set up a business bank, individually or jointly. Workers’ remittances from the West flowed into the country.¹⁹ Since the Yugoslavian current account deficit was very large, the remittances were helpful for servicing international debt. Unlike the situation in other socialist countries, the banks were allowed to run personal accounts denominated not only in domestic but also in foreign currency, which were protected from domestic inflation. Croats and Slovenians used to save mainly in foreign currencies. Personal savings, including foreign currency accounts, were guaranteed by the state in full.

The founders of banks had got autonomy from the state in the management of banking. All founders had the same voting power regardless of the amount that they invested in the bank. Workers’ councils (the councils of bank employees) didn’t have the same role in banking as in other industries. Later, big institutional depositors, which were usually at the same time big borrowers, received management rights as well. Towards the end of the socialist period their influence in running banks was modified in line with the proportion of deposits or the importance of the company which was the bank’s partner. Incestuous ownership relations between companies and banks were created at that time. The banking market in Croatia remained segmented for many more years (Kraft et al 2002). This was completely in line with the ideology that saw banks as “a service of ‘associated labour’” and not profit-making institutions. The financial system was designed to put into economic activity as much money as possible regardless of how sensible the activity was. Investments were very often guided by social goals and not commercial logic. A chronically high inflation rate was somehow built into the system.

Strictly speaking, the principle that wealth could be deserved if it was a consequence of effort, which was emphasised in socialism, was betrayed by an overemphasis on the principle of solidarity, which appeared to be practiced by printing money

¹⁹ According to UN statistics the Croatian Diaspora is 11 percent of the population. But, in the EU alone there live 750 000 Croats, which is more than 15 percent of the population. Many of them are not classified as Diaspora but as temporary workers, though they have live abroad for decades and have families there.
at the expense of all those who were frugal, prudent and responsible. Therefore, the banks were empty of sound money and long-term savings. Domestic currency had even lost its basic purpose of being a measure of value, because of chronically high inflation. People and companies instead used the Deutsche Mark, which was the most common currency of remittances from workers who lived abroad. Therefore, people didn’t count much on the financial system as a place for their personal investment but placed it instead in durable material goods, like houses and summerhouses. The system and especially its ideology dissipated and wasted work and wealth. Later in the chapters about privatisation in Croatia and Slovenia it will be shown that the regulation of the financial industry was more decisive for the process and outcome of the transformation of property rights than the initial structure; that is self-management and social ownership in both countries.

4.3 The Agreement Economy

Modelling a society according to a doctrine is not an easy task. In the 1970s the elite invented a very complex system, which was termed “The Agreement Economy”. In order to mitigate the consequences of market competition that in the Yugoslavian circumstances of that time tended to create unemployment and led to an increase of inequalities, yet trying to retain a decentralized system with the autonomy of decisions, enterprises were obliged to make “social agreements” with the local community on the financing of education, health, infrastructure and so on. The ideological and political requirements in fact harshly limited the autonomy of companies, i.e. suspended self-management. The agreement economy was actually a decentralised and less strict form of central planning. The regulation of prices and the orders as to what to produce and where to invest didn’t come any longer from the top of the Party, of which the controlling function was exercised at the ideological level. Economic decisions (about investment, etc) were negotiated and decided at the level of the local community.

20 It is usually called a dolarisation, after the phenomenon in Latin American countries where the domestic currency is virtually replaced by the dollar even in daily business, not only in savings. In Croatia it was the Deutsch Mark, which replaced domestic currency and later it was the Euro. The value of companies for privatisation was expressed in Deutsch Marks.

21 The remittances from those working abroad were also put in “mattresses”, and that “custom” endured for long after socialism: when the euro finally replaced the old currencies, the Croatian National Bank registered among the highest cash/per capita increase of savings in financial systems across old and new Europe: people brought their Deutsche Marks from mattresses to the banks to replace them with Euros.
As for the financial industry, the banks in federal republics (Croatia, Slovenia, Serbia) formed a kind of superstructure, a so-called “Associate Bank” (which, however, was not an association of banks) through which member banks coordinated big investments and commercial activities (for example, ship building). They also discussed interest rate policy and what they agreed was obligatory. Banking competition was actually confined to the race to open as many branches as possible and to attract deposits by making contracts with local companies about running the accounts of their employees who didn’t have the opportunity of choosing a bank where their salary would be deposited.

The economy was trapped in a number of intricate non-market relations and ordered to “voluntary and democratically” serve the community. “The system so created is known among economists as the ‘contractual’ economy (or dogovorna ekonomija), whose main objective in the economic sphere was to replace markets by a system of all sided bargaining among firms, banks, government bodies, political bodies and the like. The contractual economy involves many contracts, and as a result many graduates of law, business, economics, and political science schools were desperately needed ...” (Grapinski et al, p. 17) Consequently, in the period between 1974 and 1979, the number of persons employed in governmental and para-government agencies rose by 27 percent. “Whether numerous contracts negotiated among many parties could replace the market system was not a serious issue to the majority of economists... It took the deep economic crisis of the 1980’s to bring the issue to a head.” (Grapinski et al p.17)

The Agreement Economy was the response of communist ideology to the high social and transaction costs that the economy encountered in the earlier period. New business initiatives, relaxed market entry and - consequently - an increase in the number of new companies and intensified competition might help to solve such problems. The number of companies indeed increased (Sacks 1983, p. 146). The opportunity for individuals or groups of individuals to establish a company, using capital that was controlled by society, was formally opened (Uvalic 1992, pp. 161- 169), but it was impossible without the approval of the local community (politicians, led by the Communist Party). The regulatory framework of the late 1980s didn’t stimulate start-ups. Therefore, new companies were usually politically initiated, and mainly oriented to the lowering of social costs (unemployment) while productivity would not have gone up without a significant strengthening of competition. Although the entry into the product market by domestic firms was
largely free (imports were restricted), Sonje (1993) demonstrated that Croatian companies predominantly enjoyed a comfortable monopoly position.

The Party attempted to mitigate “the costs of using the market mechanism” by initiating the enlargement of firms. Sacks particularly analysed the destiny of self-management in conglomerates. The concentration of industrial power in the hands of the political and management class was in these large concerns presented as a feature of “self-management”.

The conglomerates were divided into smaller units, and the relationship between them was an imitation of market relations. They sold their products to one another according to outside market prices, if they were available. Sometimes these units also agreed to share profits. Though the units (called “a basic organization of associated labour”) were formally free to sell their products on the market outside of the conglomerate, they were reluctant to do so because, as Sacks (1983, p. 28) emphasised, they exhibited a sense of solidarity that attenuated opportunistic behaviour and lowered transaction costs.

Through the basic ideas of the Agreement Economy the Party promoted solidarity and equality and opposed competition. However, while transaction costs were internalised very often a successful company covered the inefficiencies of an unprofitable partner. The producer of car cables Elcon, from Zlatar Bistrica, a small town near the Croatian capital Zagreb, was the first company listed on the domestic stock exchange at the beginning of the 1990s. The company profile disclosed that Elcon also owned a local farm producing fresh eggs that almost went bankrupt a few years earlier. We explained above that in the case of bankruptcy the community usually organised a bail out. Therefore socialist conglomerates were often composed of completely disparate industries without having the knowledge to manage them (Sacks 1983, p. 148).

Because of the general inefficiency of the socialist economy of the 1980s, while at the same time the decision making class in the Party and in the large companies was increasing its power (and wealth), profitable units often considered the principle of solidarity to be a fraud. Dissolution of large conglomerates and outsourcing started in the 1990s, exactly when a big wave of mergers and acquisitions was registered in the developed economies. It will be shown in chapters VI to VIII that during the transition many companies in Croatia, but not in Slovenia, were acquired by multinational corporations.
5.1 Performance

During the Sixties, when its orientation toward market socialism was powerful, after overcoming a short crisis, Yugoslavia was economically very successful.\(^{22}\) In the 1960s Yugoslavia, already a member of IMF, became a member of the General Agreement on Tariffs and Trade (GATT, today the WTO) as well as an associate member of the Organization for Economic Cooperation and Development (OECD). Later, from the beginning of the 1970s, Yugoslavia established a strong formal relationship with the European Community (today EU).

The economy of Yugoslavia, in the three decades of self-management, had achieved a “great leap forward”. Between the two World Wars, Yugoslav GDP per capita was 70 percent of the World average. Soon after WWII, it was only 64 percent, while in 1960 it rose to 86 percent, in 1970 to 115 percent and then finally in 1975, the GDP per capita in Yugoslavia was 30 percent higher than the World average (Grapinski et al 1989, p. 6). There are disagreements between economists as to whether, for the first few decades, it was in fact the most successful economy in the world (Horvat), or whether it was among the most successful economies (Moore), together with the economies of Japan and the Republic of Korea. Did this success occur due to the extraordinary financial support received from the West (USA) and the clever political position of Yugoslavia, which helped in its economic cooperation with Third World countries, or was it due to its having a superior economic system? Certainly, self-management was not an obstacle for “the great leap” in the Fifties, the Sixties and even in the Seventies. The increased standard of living also helped in attracting people to the idea of self-management. The stagnant economy of the 1980s showed that the system wasn’t appropriate for overcoming the challenges that were created by internal dynamism and international competition. The question remains, how motivating was the egalitarian concept, which is an unavoidable part of self-management?

5.2 Summary and brief comment

In this chapter I have described the evolution of self-management and social ownership in Yugoslavia. I have identified three moments important for the emergence of self-management: the tradition of peasants’ cooperatives; the need for better economic coordination; and political conflict that influenced the introduction of the new variant of socialism, so-called market socialism.

\(^{22}\) GDP grew on average 7 percent annually
A pure theoretical model describes self-management as a variant of the labour managed firm. While the classical capitalist firm maximises profit, the labour managed firm maximises income per worker. Early analyses (Ward, Vanek) demonstrated that self-management might be competitive under particular conditions. In the case of an incomplete market self-management requires regulatory support for the optimal allocation of resources. The political system in socialist Yugoslavia was decentralised, and so were the financial system and ownership rights after the abandonment of central planning. While domestic authors (Uvalic, Horvat) conclude that bureaucracy suppressed self-management, Furubotn and Pejovich conclude that self-management wouldn’t be viable without regulatory support.

Instead of a static analysis, the self-management system of property rights must be viewed from a dynamic perspective. Self-management was perhaps an appropriate structure for small companies at the beginning of its development. Later, the workers’ councils in larger companies often took the role of unions in capitalism. Development of the economy influenced the rise of a class of professionals and a management class. Their higher participation in the use of a flow of income from resources was prevented by communist egalitarianism. Flaws of the self-management system were clearly visible in the banking industry. Since the principles of self-management weren’t appropriate for running a bank, workers’ councils in the banks didn’t have the same role as they did in other companies. The development of the financial system (banking) followed and reflected changes in the ownership regime and in the market. Banking was decentralised but the Party at a local level strongly controlled the allocation of financial resources. In the chapters about privatisation in Croatia and Slovenia particular scrutiny will be devoted to the destiny of the management class and to the development of the financial system.

5.2.1 Ownership structure and the self-management legacy

Furubotn and Pejovich conclude that the self-managed firm is not a viable ownership structure because: 1) Property rights over capital were divided between the community and workers and the transferability of capital was restricted; therefore workers’ councils were reluctant to invest. 2) The growth of the wealth of the firm didn’t increase the wealth of those who contributed to that increase by their decisions or by the input of skilled labour; the divergence of interest between workers and management was noted. Both objections have the same
common denominator – property rights in self-managed firms weren’t clearly and adequately delineated. While there is truth in these objections it shouldn’t be concluded from them that an ideal ownership structure exists which is efficient for all kinds of resources and institutional environments. It was explained in chapter III, section 4.3 that the success of a particular ownership structure depends on such things as the size of the company, the technology of production, the characteristics of assets, the characteristics of the market in which the firm has to win its competitive advantage and survive (Fama & Jansen 1983). The local public body was responsible for the control of the use of resources and had the right to endorse the manager that was selected by workers’ council. Abstracting from the influence of the party and communist ideology of the equality of income, the heaviest burden on self-management was the restricted transferability of company’s savings and investment (capital). Accordingly, self-management was not an adequate ownership structure for the financial industry.

However, it was shown in the previous theoretical chapters that a general framework of principles and beliefs that holds together a particular property regime always exists. Looking from this side, the rights of local communities to control resources and endorse management were extensive, but not generally unacceptable; in the countries with market economies, social norms often impose restrictions on the use of resources and affect the selection of managers. The viability of various forms of collective ownership is also explained. Society employs principles and beliefs to regulate formally and informally the use and transferability of property rights, while owners of property rights individually or collectively use resources. Though self-management and social ownership weren’t efficient it doesn’t imply that the problem was a division of the use of resources and restrictions on transferability of capital as such. The problem was that (1) the ownership structure was enforced for all resources without possibility of its evolution and (2) an inadequate regime for the transferability of financial capital.

Furubotn and Pejovich noted the divergence of interests between workers and management. This - in my opinion - signifies that the self-management economy developed in such a way that the evolution of its ownership structure was necessary. The changed characteristics of business activities required a transformed financial system. Principles of distribution of income favoured low skilled employees. This legacy of income equality, collective consumption; non-pecuniary payment, and such a wide participation in business decisions that the
proclaimed autonomy of the company and professionals in their field of expertise was effectively suppressed, was in conflict with what was needed for the necessity of development of the property regime.

It was mentioned in chapter II (section 3.4 *The distinctive feature of initial appropriation*) that the Slovenian economist Bajt considered the priority of reforms to be to liberate the relationship between employees inside the firm; for instance, the abolition of the narrow proportion between the highest and the lowest wages that would open the market for those with skill and knowledge. The next chapter about the privatisation debate will show that Croatian economists were focused on a formal reform of the ownership structure, while the important legacy of the economic culture that was developed under the system of self-management was neglected.
Chapter V

The Privatisation Debate

During the 1980s the self-management economy entered a period of painful stagnation. Consensus was reached about the necessity for reform of the property rights regime. In this chapter I will firstly describe the reforms made within the socialist framework and how they failed. In the middle of the 1980's privatisation was proposed. At the beginning, intellectuals, then professionals and business people, advocated privatisation and after a while - when it was accepted by the majority of politicians - the entire elite in Croatia and Slovenia was in the pro-privatisation camp. Privatisation was seen as a solution to the problem of how to stimulate a stagnant economy, that was what at the time the aim of privatisation was understood as being. But what structure of market and property rights was to be achieved? What did those involved expect that a privatised economy would look like? And, indeed, what was their understanding of private property? These issues will be examined by way of looking at various ideas that were proposed about privatisation, and how those ideas conceptualised the method of privatisation. After the presentation of the socialist reforms, I will analyse which kind of property and which kind of market were articulated within the privatisation debate. I will also explain how the discussion about privatisation led to the consequence that privatisation took a form of an initial appropriation in Croatia.

1. The latest reforms within socialism

In the second half of the 1960s, when the general trend toward a market economy in Yugoslavia occurred, the replacement of self-management by workers’ shareholdings was proposed. The idea was initiated by the premier of Slovenia Stane Kavcic, but politicians and economists in other federal republics of the former Yugoslavia expressed the same understanding of how to reform self-management. Kavcic concluded that financial reforms should open opportunities to employees and citizens to place their “surplus money” into “an enterprise which could invest it, return interest and perhaps a little more, according to the net profit realised” (Antic 1971). It should be noted that the “surplus money” that was found among
individuals and inside companies was referred to as “past labour”. Ideologically, this was very important since communists usually claimed that the source of all wealth was labour and not capital. Now the origins of capital were found in labour, but “past labour”. Kavcic was particularly concerned with surplus money in successful companies that they were willing to invest in other companies but where the regulations prevented them from acquiring control of their investment by means of any form of ownership. Kavcic concluded that socialism should create instruments for the integration of companies; among these instruments “should be the investment of private capital in the socialist sector and the participation of private capital in realised returns” (Antic 1971).

Kavcic’s ideas were harshly rejected, critics claiming it was an expression of a managerial tendency to form an alienated “group ownership” (Likic Brboric 2003, pp. 109-112), which in this understanding would be opposed to workers’ interests. In fact, the Party leaders were afraid of losing their influence in the economy if a class of managers of big companies should be formed. The question remained how to motivate collectives to save and invest, and to refrain from maximising wages at the expense of investment and to postpone consumption.

Discussion was conducted in ideological language - about the relative importance of labour and capital in the creation of new value, according to Marxist teaching. The proponents of pro-market reforms insisted that socially owned assets could not be used rationally without the recognition of “value in past labour”. Former workers of a company, who had had deductions made from their wages to invest in the company, were under the system of that time prohibited from “using the fruits of their efforts”. It meant that the workers who left the company were prevented from enjoying the benefits of the investment in which they participated while they were employed in the company. Victory in the debate went to the advocates of the proper valuation of past labour (Uvalic 1992, pp 157 – 161), but the outcome was that workers with a longer employment period in the firm obtained a higher salary (bonuses per year of employment). Such an outcome did not solve the problem how to motivate workers to invest.¹

During the 1980s a lot of initiatives to improve the financial market were undertaken. Several investment instruments suitable for the system of self-

¹ Bonds as a form of rewarding past labour were proposed many times, among economists and even among leading politicians. Transfer of claims based on past labour to pension funds was also proposed but never seriously discussed (Dubravic 1970).
management were introduced, but success was very modest. Joint investments and private investments were over-regulated. The investment that private investors could make was usually limited in time: when the initial investment by a private investor was repaid (with interest) workers that were engaged in this enterprise had the right to take over ownership. If one company invested in the capital of another, also employing workers of the company invested in, priority in income distribution belonged to the company invested in. The possibility of a permanent share in the income of the enterprise invested in was explicitly excluded, which discouraged such investment.

From the beginning of 1970 there were sporadic attempts by companies and local communities to issue bonds. In the 1980s, the possibility for public persons to sell fixed income and profit related financial instruments was regulated, but these attempts weren't successful due to the absence of a secondary market for securities. The opinion that a secondary market for securities was “directly in conflict with the self managed economic system” prevailed. It was claimed that an efficient capital market must be liquid and it was deemed that this implies that speculators will dominate it and that their interests would prevail over the interests of the labourers (Uvalic 1992, pp. 172 – 173). This was considered unacceptable. An efficient market for securities also requires an autonomous banking system. But banks under socialism were considered “a service of associated labour”; that is, they were under the control of the companies that were their founders, and therefore they never took up the role of independent financial intermediaries. Since private ownership was restricted, the possibility of the establishment of a bank that was owned by individual depositors was not allowed. The power of ideology is notable here. These failed attempts to modernise socialism formed the immediate background for the discussion of privatisation.

2. Public ownership, private ownership and “no-ownership”

It was explained in chapter IV how – under the system of self-management – the bundle of property rights was allocated between the state, local community,

Under communism, which called itself scientific socialism, ideology (that promotes values) and theory (that investigates causes) were firmly intertwined. The discussion about past labour is an example. The question was whether capital might be understood as past labour. If yes, capital might be acceptable to be a source of added value. The outcome of the discussion affirmed the value of capital. Nevertheless, when the ideologists (theorist-politicians) who won the battle were criticised on the grounds that the ideas as implemented were in fact a misinterpretation of their original intention, they answered, “it was a technical issue” (Uvalic 1992, pp. 172 - 173). They believed that winning the ideological battle was enough for victory.
workers’ collectives, managers and individuals. If property rights represent the power to capture income from a resource, then the state acquired taxes, local communities forced companies to finance “collective consumption” (libraries, local arenas, hospitals), and workers were eager to transfer their entire residual earnings into their wages, since they didn’t control the gains from investments. A community, represented in a particular public body, had the right to control a resource (i.e. a company) and the right to endorse (or refuse) the manager that was elected by the workers’ council (and often proposed by the Party). Workers’ councils had the right to endorse (or refuse) strategic decisions of a management body, while other business decisions (making contracts, setting prices, and so on) were the responsibility of management. The regulatory framework was strict; it was not easy to lay off a worker; minimum wages and the proportion between the highest and the lowest wage were regulated. The influence of ideology on the distribution of wealth was significant. However, this is just an illustrative general framework; over the forty years of self-management from 1950 – 1990 regulations changed frequently.

Certainly, the system of self-management and social ownership was complex. I mentioned in chapter IV that it was a combination of workers’ cooperatives and communal ownership. A proportion of income flow from a resource belonged to workers (individuals), another proportion to the community, and the third to the state. The right to control a resource and management rights were also dispersed. The system of self-management and social ownership is a very good example for discussion of the questions that were analysed in chapter II: what constitutes ownership, and what is the distinction between public and private property? These questions were the subject of the debate on privatisation. In this chapter I will be focussed on the discussion in Croatia, giving only occasional insights into the ideas that were raised in Slovenia. More details on the privatisation debate in Slovenia will be presented in chapter VIII.

As for the questions of who was the owner of the self-managed firm and whether it was private or public property, three positions were taken: (1) it was already private property; (2) it was a form of public ownership and, finally, for many Croatian disputants social ownership was (3) “no ownership”. There was no similar discussion in other Eastern European countries. Depending on the answer, three programs of privatisation, in fact three programs of transformation of self-management, were proposed.
I will quote typical statements that support each of the three abovementioned assessments.

(1) Self-management is already private property:
From the legal point of view, ownership is state and private (nongovernmental) ownership. From this point of view, cooperatives and social corporations, although collectively run, belong to the private sphere. Under social ownership, enterprises are run by workers, i.e. by private individuals and not by government employees. Private ownership may be a personal (family) or collective one. Since it would be both illegal and contradictory to privatise private ownership, the same conclusion applies to social corporations. But it makes sense to transform capitalist private ownership into socialist private ownership or vice versa. (Horvat 1993/2003)

(2) Social ownership is public property:
This type of ownership has been given different names in different countries and in different periods (social ownership, state ownership, common ownership, public ownership, and collective ownership), but its basic economic and political consequences are the same regardless of the name. Reforming a socialist economy is no longer possible without addressing and challenging the public property issue explicitly. (Grapinski et al 1989 p. 237)

(3) Self management and social ownership are no-ownership at all:
In practice social ownership seems to suffer the fate of communal lands in some capitalist countries. Since it is no one’s property, its condition depends largely on the ability, the determination, and often the sense of responsibility of the workers who use it. In the statutes that regulate behaviour in enterprises, there is frequently an implicit understanding that social property is worth less than state or private property. An example is provided by cases of theft by employees. In most situations where the theft is minor, the employee will not face legal charges but rather will answer to a disciplinary commission, which administers punishment as it sees fit. (Grapinski et al 1989, p. 33, my emphasis)

It is easy to recognise in the above quotes the criteria for the distinction between private and public that were presented in chapter II. In the first interpretation, all non-state ownership was considered private (option 1). Alternatively, all forms of collective property were considered non-private; consequently only individual
property was considered private property (option 2). The third option that social ownership is no-ownership is the most intriguing. The above quote follows reasoning similar to that of Garrett Hardin (1968) in the paper “The Tragedy of the Commons”. Hardin concludes that any form of common ownership inevitably ends in an overuse and destruction of resources, since a rational user is concerned only about his own costs when he makes demands on resources and ignores costs imposed on others. Hardin’s alternative was “either socialism or the privatism of free enterprise” (Ostrom et al 1999). This is a similar conclusion to one that identifies any form of collective ownership with open-access (chapter II).

The no-ownership assessment of social ownership was widespread though nowhere and never thoroughly elaborated by anybody. The common and simple argument was that social ownership was everybody’s ownership; hence it was nobody’s ownership (Uvalic 1992, p.154). This “hence” didn’t have a meaning other than that social ownership meant open access. This wasn’t true (see chapter IV). I would like to recall here that there have been examples of communal ownership (land, irrigation systems) that were successfully protected and weren’t overused (Ostrom et al 1999).

The rhetoric that social ownership was nobody’s ownership could be interpreted as an overexcited demand for the immediate transformation of the property regime and a clear delineation of rights. Those who were more cautious took the view that social ownership was “ill defined” (Skreb 1994). The idea of social ownership as nobody’s property fits the hypothesis that privatisation in Croatia took the form of an initial appropriation. This hypothesis can be comprehensively assessed only after a thorough description of the debate and the process of privatisation in the chapters that follow.

The no-ownership assessment of self-management found a way into the first Croatian privatisation law (LTSO 1991 - The Law on Transformation of Social Ownership). The opening sentence states that the Law governs the transformation of companies with “social capital” into “companies of which an owner is known” (identifiable, recognisable; LTSO 1991, my translation from the Croatian). The next sentence explained why social ownership was considered ownership by somebody who was not known. Into the company were invested “social funds, but on that basis ownership rights weren’t acquired” (LTSO 1991 – my translation). Whether this assessment of the system of self-management was correct or not depends on the definition of ownership. It was argued in the previous section
that companies that invested in other enterprises had ownership rights limited in time, but local communities that invested in an enterprise had the right to control business activity. According to the Law, privatisation was to create financial instruments such that an investment in them produces “ownership rights”. Therefore, the control of business activity and limited rights to capture income were not considered ownership rights; advocates of the Law didn’t explain explicitly what they considered "ownership rights” to be.

3. Methods of privatisation

The proponents of public, private and “no ownership” characterisations of self-management each advanced distinct methods of transformation of the property regime. According to the above quote (1) if self-management was considered already to be private then only private owners (employees) can decide about the rearrangement of the ownership structure of their companies. Self-management might be transformed into some other property arrangement under the influence of market forces. A change in the law should allow these options. In the chapter about self-management it was explained that employees had the right to distribute among themselves the residual income but that the transfer of this right was prevented. Position (1) proposed the introduction of the transferability of the right to residual income. It will be shown later that the proponents of this view were against radical reforms.

The position that under socialism the ownership of companies was public property (2) implies that – in order to privatise – the Government might employ one of two methods: the selling of state owned assets or their distribution. The above quote (2) shows that the proponents of this understanding of social ownership didn’t respect the distinction between collective non-state owned and public state-owned property. Since social ownership in any of its variants was considered de facto public property, it was to be sold to a private owner so that all components in the bundle of property rights could be unified. As for the method of distribution of property rights (shares), it was assumed that market exchange would lead to the unification of components in the bundle. The question for these people was which method is more efficient in terms of speed and which method will allocate property to the more efficient owner.

Most interesting are the conclusions about the method of privatisation from the position that self-management was “no-ownership” (3). One of the options was original assignment, for example that workers and management as incumbent...
on the assets should take over full ownership rights. Those who considered self-management already to be private property proposed the same arrangement. The advocates of a no-ownership understanding were against the legalisation of self-management for two reasons. First, self-management as a form of collective property was not competitive any more and legal recognition could not improve it (Babic 1992; Cuckovic 1998). Second, the distribution of wealth would be uneven (Babic 1992). The employees in successful companies would acquire more valuable assets than employees in unsuccessful ones, though it was not considered that they exclusively were responsible for the success of the company.

Instead of an original assignment of nobody’s property, another option was nationalisation and then distribution or selling. The proponents of the no-ownership position were afraid that nationalisation might mean a return to orthodox socialism that could last. They advocated the distribution of privatisation coupons. Discussion of this will come later. It was assumed implicitly (and very often explicitly) that the assets should be assigned only to individuals, since collective ownership in any form was considered ill defined, that is, no-ownership. However, this is not true for collective ownership in general, since some resources wouldn’t be exploited efficiently without collective endeavour (chapter III, section Individual and collective ownership). Nevertheless it is understandable that the reform of self-management aimed to minimise the administrative distribution of income (by voting), which is a characteristic of collective ownership.

This short description of the initial theoretical positions already shows that the reasoning about privatisation in Croatia shared some important characteristics of an initial appropriation as it was described in chapter II. (1) It was discussed whether incumbent owners should formalise their economic ownership. (2) It was expected that all assets were to be disposable for re-distribution, whoever controlled them under socialism (except strategic industries). (3) Moral criteria of redistribution were discussed. The most important was that (4) reasoning about privatisation led to an analysis of methods for the re-distribution of property (assets) while the definition and allocation of property rights was neglected. This is closely connected with the fact that (5) discussion about the characteristics of the market was postponed until the period after distribution. In regard to points (4) and (5) I would like to recall Coase’s (1960) conclusion that “what [the owner] in fact possesses is the right to carry out a circumscribed list of actions”. It is important to recall that characteristics of the market, i.e. the rules that govern exchange, depend on the property rights that were to be exchanged and on the
attributes of assets. The institutions (formal and informal) that regulate the transfer of rights to control and use tangible property are distinct from the institutions that regulate the exchange of the right to residual income. Since the concept of the market was the weakest element of privatisation in Croatia I will come back to the above conclusions later.

To summarise for the purpose of further analysis, the privatisation debate in Croatia didn’t carefully observe: the distinction between property and property rights; or the distinction between public, collective and individual property. In my opinion this affected which concept of the market was promoted. The relationship between property rights and the market in such a framework will now be investigated. I will first compare position one (already private) and position three (no-ownership).

### 3.1 The transferability of property rights

The most active advocate of self-management and social ownership, and almost the only one among economists in Croatia at the beginning of the 1990s, was a Marxist-socialist scholar Branko Horvat. In his view self-management was already a form of private ownership. In 1991 Horvat himself proposed a draft of a law on the transformation of the property regime. Basically, the opportunities for different arrangements of property rights were to be opened up, and therefore his proposal was described as allowing for the “coexistence of social and private ownership”. The purpose of his Law on Social Corporation (Horvat 1991) was the establishment of the autonomy and independence of companies from the state. It represented continuity with the long-term struggle of the believers in self-management who argued that this ownership arrangement had never been given a real chance.

According to his proposal, self-managed companies would register themselves with the court and become incorporated. Most of the stipulations of the proposal were oriented towards retaining collective ownership. Workers would elect an executive following the one employee - one vote principle. A Social Corporation could issue

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3 In fact, Horvat’s social ownership was at the same time private and public. I have already quoted his assessment that social ownership was private property (the section “Public, private and ‘no-ownership’”), and in the discussion on privatisation he emphasised this private side. As for the public side he wrote: “Next, state ownership and public ownership are not identical. Social ownership is an example of public ownership, but so is state ownership. Public ownership includes some other non-state forms such as non-profit firms. In England, the corporations issuing shares are called public companies.” (Horvat 1993/ 2003, p. 153)
shares and bonds; hence it could allow for mixed ownership between internal and external owners. If internal owners dominate, they manage the company autonomously. The proposal restricted the transferability of internal shares. These shares, in the treasury of the company, are not nominated to a particular individual (worker) but to the entire company. The company can be transformed into other forms of ownership in case of bankruptcy, or after a hostile or a friendly takeover.

The above proposal represents a variant of a possible evolution of the property regime in Croatia. Similar concepts were discussed in Slovenia. Alexander Bajt (1990) agreed with the view that ownership rights under socialism should be recognised and formalised. The problem that workers in capital-intensive companies, where society has invested a lot, would be in a much better position than workers in labour intensive companies Horvat attempted to solve by the restricted transferability of the equity of the company. Bajt proposed allocation of ownership so that the assets would be divided between workers and the state. The net income from previous years that wasn’t distributed in wages but invested in the company should have been, according to this proposal, distributed to the workers. The rest would belong to the state. Bajt obviously believed that the assessment of the proportion that belongs to the state was technically possible following accounting reports.

3.2 Tunnelling

A key problem facing the model of coexistence of different ownership regimes was that it didn’t consider seriously the possibility of pulling out assets from a social corporation into a private one at the expense of the collective owners. The technical term for this phenomenon across the transitional countries was “tunnelling” (Johnson et al 2000). It was also called “informal privatisation”. The phenomenon of tunnelling accommodates itself to the formal and informal regulation of the market. It was demonstrated that in the developed civil-law countries such as France, Italy and Belgium the transfer of assets from the company at the expense of minority shareholders was also legally possible and frequent (Johnson et al 2000). The intensity of the phenomenon depends not only on formal regulation but also on informal rules and on the attitude towards ownership. A “small theft” that was mentioned above (quote 3), which was used in the argument that social ownership was no-ownership, expresses how those who should have protected social ownership treated resources under their control. Since collective ownership in any form wasn’t considered efficient, informal rules didn’t protect assets effectively. It is also true that the assets withdrawn from a particular company
(socially owned) might be used more productively in another one (privately owned). The problem was that the chances to participate in the allocation of such resources weren’t equal: the management and politically privileged people were in a better position to privatise in this way. The phenomenon of tunnelling, i.e. withdrawal of assets at the expense of other owners (those who have rights upon income flow) implies that the exchange of assets is not transparent.

A description of the processes of privatisation will show that the solutions of the problem in Croatia and Slovenia suited their different economic cultures. Bajt emphasised the necessity for the strong legal protection of assets in the period of “coexistence of private and social ownership” and strict legal control of management behaviour. Slovenia conducted scientific research into tunnelling in its earliest stage, at the beginning of the 1990s. Precisely because of various forms of tunnelling the development of the market for property rights was there observed carefully and reforms were made step by step. The Croatian solution was developed under the strong influence of interest groups.

The analysis of privatisation in Croatia and Slovenia in chapters VI to VIII will demonstrate that the problem of the transformation of social ownership was more a problem of the development of a market than the problem of the transfer of property. The phenomenon of tunnelling is a litmus test of the characteristics of a market. It shows that not every transaction concerning property leads to more efficient use of resources (for example in case of the transfer of property into the hands of a dominant shareholder if dispersed shareholding would be more efficient, and vice versa). While in Croatia it was propagated that the market emerges instantly after privatisation, in Slovenia the approach was taken that this process is incremental and that an instant establishment of an efficient market is not possible. Horvat’s proposal didn’t neglect the possibility of tunnelling, but his solution would have imposed limitations on market exchange that would have been as strong as they were under socialism. Horvat was aware that self-management would be unlikely to survive without protection. This fact implicitly confirms that not even proponents of self-management were able to argue that it could be preserved without regulatory support.

### 3.3 Elimination of incumbent owners

The proponents of the characterisation of self-management as no-ownership attacked Horvat’s conception. In 1991 a group of leading Croatian economists,
among them a few former Croatian ministers for privatisation, argued that social ownership should be transformed so that it becomes “ownership with a defined [identifiable] bearer of ownership rights” (PPED 1991, p. 35). Here I will translate their long comment on Horvat’s idea:

Some theorists think that the solution for the problem [of how to privatise social ownership] is the direct transformation of a social company in such a way that it becomes the owner of social equity. [They propose this approach as a] simplification of the existing system since their solution excludes the community and the state from the management of companies, but in essence the problem remains the same. Indeed, everywhere the firm has [particular] ownership rights and the firm’s assets are the guarantee for liabilities toward creditors. This proposal doesn’t solve the basic problem of who owns the firm. The company can be a subject of market exchange; it must be saleable or purchasable. A final owner of its equity cannot be the firm itself; because the firm is in somebody’s ownership, but the basic problem of our system is that it is not known in whose ownership it [the firm] is. The capital market is predominantly the exchange of companies through financial instruments. It must be known who has a legal right to sell the company. The claim that the firm owns itself implies a misunderstanding of the role of a company in a market economy. It [this proposal] could be acceptable for the existing management structure, which behaves like a quasi-owner of a social company, but it doesn’t contribute to the transparency of ownership rights. If the company was sold, who would receive a payment, and whose would be the revenue? It cannot be the company but only another agent, legal entity or physical person. Social ownership, which is defined as no-ownership, cannot be saved through claiming it to be ownership of the company. The basic purpose of the transformation of ownership is to find a final owner, which can make that ownership become the subject of market exchange; and that would establish preconditions for the realistic valuation of capital, for its mobility and for its rational use following the criterion of profit maximisation. (PPED 1991, pp. 36-37, my translation and my emphasis.)

This long quote is one more indication that the no-ownership characterisation of self-management was widespread and taken for granted. The goal of Horvat’s critics was clearly the establishment of a capital market and transferability of ownership.

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4 This is the report from the discussion about privatisation which was organised by the Institute of Economics, Zagreb; the report was already quoted in chapter I
To do this it was not necessary to advance the claim that social ownership wasn’t ownership. One quasi dilemma was discussed: who would get the money when the incorporated self-managed company (now a workers cooperative) was sold? In Horvat’s view, if a firm was sold the money should go into a special fund owned by the state. Other authors proposed a solution in which part of the revenue belongs to the workers. Though it was not clearly explicated, the attitude toward the market was a key distinction between Horvat and his critics. Two particularly important issues should be noted:

1. The critics assume that the incorporation of a self-managed company would prevent the development of a capital market.
2. It is concluded that Horvat’s proposal would be favoured by the existing management structure. Critics call the existing management quasi-owners.

I will comment on these issues immediately.

1. The financial market was the weakest point of the system of self-management. It will be demonstrated that the financial market remained the weakest point of the process of privatisation in Croatia. In my opinion this weakness was a consequence of a misconception about property rights. Horvat’s weak point was the restricted transferability of the ownership of capital so that under the arrangements that he was proposing the market price of capital was not transparent. It was the same under socialism. Because of the restrictions upon the transferability of capital, financial surplus was transferred into income and was oriented to personal savings or expenditure. Due to bad management of the banking system (a high inflation rate), the surplus ended up in consumption or in non-productive investment (building houses and so on). Horvat justified restrictions on the transferability of ownership over capital by the necessity of avoiding “speculation and exploitation.” It is consistent with his idea “to connect ownership with labour and not with capital” (Horvat 1990, my translation).

Critics of Horvat’s idea didn’t recognise that the transferability of ownership is always somehow restricted (regulated, formally or informally). Since Horvat’s critics missed addressing the question of which rights would be transferable, they missed analysing the characteristics of the market that was to be developed. If the right to residual income was to be exchangeable, then it must be possible to conclude confidently when and how this right can be exercised, how to protect
this right or increase it, to what degree this right depends on the performance of a company, under which conditions this right can be cancelled and so on. Similar questions arise if the rights to control and manage resources (stock of flow) were transferable. Developed markets for securities require a strict procedure for the investigation of assets, transparency and an efficient settlement of payment. A system for the punishment of offenders is developed and known to participants. I think that the belief in the principle of deregulation prevented this discussion from occurring. Instead of open academic debate the design of the future capital market was left to the activities of interest groups.

(2) Proponents of the no-ownership position wanted to develop the financial market by ignoring the existing owners, claiming that the workers and the community were quasi-owners, or no-owners, who were “remnants of socialism”. However, they weren’t quasi-owners at all. They had the power to manage the company and to collect income from it. Horvat’s critics attacked the incorporation of social ownership concluding that it would stimulate the capital market which would favour incumbent owners, managers and workers. Even if they didn’t consciously favour any interest group, they didn’t see that their solution wasn’t neutral. In my opinion, the analysis of the perfect market in chapter III (section 2.5) confirms the impossibility to construct a market that puts all participants in the same position. In regard to the equality of market participants the distribution of vouchers was proposed. The deficiencies of this proposal (in regard to its supposed neutrality) will be shown below.

4.1 The market and the role of the state

The position “already private” was very soon ousted from the public scene. Further discussion was only about a method of allocation of resources to possible new owners. As was the case in other transition countries, two methods were discussed. In the first camp were proponents of the distribution of assets, using privatisation coupons or vouchers. According to the second group, the state should organise the selling of companies. The method of distribution was called “spontaneous privatisation” (Babic 1992). The second method was referred to as “slow privatisation”. Therefore, two criteria for distinguishing the methods of privatisation were introduced: selling vs. distributing; slow vs. fast privatisation.

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5 Ten years after the beginning of the process the incumbent owners who lost their property rights (employees, local communities, and small shareholders, assisted by the unions) attacked privatisation and its outcomes. I will come back to this point in chapter X.
The discussion about the method of privatisation was similar in the countries of the Soviet bloc and also in Britain, though their property regime was different.\(^6\)

Despite the fact that the content of the discussion about the two mentioned methods is well known from other transition countries I will describe it briefly here, using Croatian sources, setting the scene for our further analysis.\(^7\) In 1992 Croatian economists from the Institute of Economics, Zagreb created *The Conception and Strategy of Economic Development (CDERC 1992)*\(^8\) of which privatisation was a cornerstone. The problem of the method of privatisation was described in the following way:

All strategic dilemmas of privatisation can be synthesised in the following chain of mutually dependent problems: fast or slow privatisation – just or unjust privatisation – distribution or selling of state owned assets – the state coordinates the process or the state collects the revenue from the sold companies – maximising privatisation or maximising the revenue from sold companies – financial restructuring of companies before privatisation or leaving it to the new owners. (CDERC 1992, p. 20, my translation and my emphasis)

The authors advocated the first element in the chain: fast and minimally unjust privatisation – distribution of ownership (the combination of distribution and selling was acceptable as well) – the state only a coordinator of the process – maximisation of privatisation (the revenue from privatisation was not a priority) – new owners should conduct the financial restructuring. However, one may imagine a different combination of the first and second elements, for

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\(^6\) It is possible to find almost all the arguments of the two opposing sides in the discussions in other countries. See Estrin (1994)

\(^7\) The analysis of the transition so far hasn’t confirmed which of the two methods was more successful. It perhaps depends on the circumstances in a particular country. In the mid-1990s the Czech model of rapid and massive privatisation was judged a great success. However “as more information became available and problems of both performance and fairness surfaced, the consensus interpretation shifted in 1997-98 sharply toward the negative.” Countries which adopted a method of “slow” privatisation such as Poland and Hungary, were favoured especially in comparison with the rapidly-privatising Czech Republic and Russia. It was emphasised that quick privatisation in the wrong environment could have the wrong effect altogether. Birdsall and Nellis note that “the pendulum has once again swung back” when the Czech Republic returned to vigorous growth. Privatisations in other countries, in the UK, Argentina, Russia passed through the same shifts in interpretations and judgments. (Birdsall and Nellis 2005)

\(^8\) It is important to note here that the leading author and editor of this Conception was Borislav Skegro, who later became vice prime minister for the economy. Skegro (2007) explained that *the Conception* was the informal program of the Government.
example fast and unjust privatisation. The authors explained that their choice was motivated by the intention to limit and minimise the role of the state in the economy and to liberate more space for market forces. To this general approach there was no opposition though it is not easy to see what kind of market was advocated: a competitive or monopolised market; a transparent or opaque market; a regulated or deregulated market. Consideration of dilemmas such as these was missing.

The proponents of the fast distribution of ownership rights described what would happen if their strategy wasn’t accepted. The majority of assets would remain in the ownership of the state for a long time; demonopolisation would be slower; the development of a financial market wouldn’t happen; the underdeveloped financial market would open the possibility of manipulation of the value of companies being sold; state administration would grow (CDERC 1992, p. 20). Then it was claimed that:

The privately owned economy cannot be a counterpart on an equal footing to the state fund that manages state assets and concentrates economic and political power. A small number of people in the fund, and people connected with the fund, would manage other people’s assets, without sufficient insight and control, similarly to how it was in the earlier period [socialism]. Taking from good performers to save bad performers would happen again. All of that would end up in an increase of unemployment, a decrease in the standard of living and in motivation, and in emigration. (PPED 1991, p. 83, my translation)

In fact, the advocates of fast privatisation accused their opponents (who proposed a slow selling of assets controlled by the state’s fund) of advocating the preservation of socialism. The first Croatian Law on the Transformation of Social Ownership didn’t accept the distribution of vouchers as a method of privatisation. The following chapter VI, which analyses the accepted method of privatisation, will show that despite various discounts, and many privileges for workers and other groups of citizens in the process of acquiring social ownership, a large proportion of capital finished up in the hands of the state. The question is, why was such an approach accepted despite early warnings? Firstly, interest groups and real-political circumstances influenced the government to take a major role in the process of privatisation. And secondly, the advocates of the method of distribution weren’t persuasive enough. Often their project looked more like a theoretical exercise
supported by a set of slogans about a free market and individual choice than a feasible project.

Before an analysis of the method of distribution I will refer shortly to the political realities and the influence of interest groups. The nationalists opposed the distribution of vouchers claiming that it would open an opportunity to a smart investor, for example from Serbia, to acquire some key assets. In a fervent public atmosphere it was a persuasive argument. The method of sale using public tender enabled the Government to more easily control the buyers. However, various interest groups advocated the method which would give them – they believed - the opportunity to negotiate directly with the government and influential politicians. One of the groups was the Croatian Diaspora, which financed the political campaign of the ruling party before it took power in the first multiparty elections. These groups were opposed to distribution. For particular strategic investors from the West, it was easier to negotiate directly with the authorities than to wait for the spontaneous emergence of an organised and transparent market (after the distribution of vouchers). Supported by politicians from their own countries, they took the opportunity to acquire substantial assets in banking and infrastructure through direct negotiation with the Government.

Academic critics of the voucher proposal argued:

The idea of privatisation becomes popular, even fashionable, just like the idea of nationalisation (after WWII)... or the idea of self-management. It was then stated that a worker self-manager will decide about [what was called] the totality of re-production [all commercial decisions concerning an enterprise]; while today the same agent, having a new name – the shareholder will do the same thing. (Babic 1992)

It is interesting that here various forms of ownership, in fact distinct property rights, were explicitly argued to be equivalent. The conclusion, which was derived from this historical comparison, was that ownership doesn’t matter but only efficient management. It was proposed that the biggest firms should - for the purpose of an increase of efficiency - import hundreds of managers from the West.

9 Serbia at that time openly supported ethnic Serbs in Croatia against the Croatian Government

10 The discussion occurred before the war.

11 Fortunately, they were later more successful in managing their assets then were domestic political clients.
It was assumed that a radical transformation of the property regime introduces instability, initiates damaging speculation and “a chasing for social wealth” (Babic 1992). The transformation of the property regime was not considered a priority; the discussion about a market for property rights was again neglected.\textsuperscript{12}

It seems that both positions were more persuasive in the criticising of their opponents than in the designing of a realistic project of privatisation. I think that this was not incidental. The lack of feasible models was in fact a consequence of the superficial understanding of the market mechanism in general and the lack of analysis of the Croatian market and economic culture in particular. However, it is not possible to prove that the concepts of property and market that formed the framework for the discussion of privatisation directly influenced the process. But it is possible to emphasise the parallelism between what happened and what was promoted. Theoretical models structure unstructured outside worlds and legitimise the activities of agents who claim that the outcome will be as they advocated and predicted in the theoretical discussion. Now I will outline, analyse, and comment on the misinterpretation of the market, as it appeared in the “voucher proposal”.

\textbf{4.2 The market without information}

The model of distribution usually supposes that all citizens, or selected fractions of citizens (adults, or employed people), receive a portfolio of shares of all the companies to be privatised, or a voucher denominated in a particular amount of points. These vouchers are then exchangeable for the shares of a particular company in public auctions, or may be invested in a fund that competes at the auctions of shares of companies. The following analysis is not a criticism of the voucher model as such. This criticism is oriented predominantly towards the theoretical arguments that promoted voucher privatisation in Croatia, and particularly to the strong claim that the assets to be privatised at public auctions should not be valued prior to the auctions taking place.

\textsuperscript{12} One might think that there is a similarity between this understanding and the understanding of property rights theorists in Slovenia (Mencinger and Bajt) who insisted that privatisation should not destroy a company (resource). This reasoning is superficial. Both Slovenian economists insisted on such a development of the market for property rights which would increase the efficiency of the use of resources. For example, Bajt proposed that an initial step in the reforms should be the removal of barriers to the market for intangible property inside the firm (skills, knowledge, experience). We remember that the regulation of that market was rigid under socialism. Mencinger proposed that firms themselves prepare the program of privatisation (Bajt 1992, Mencinger 1996)
The distribution of a mixture of shares or vouchers was in Croatia mainly advocated by those who were opposed to the selling proposal. The model of distribution was briefly described in *The Conception and Strategy of the Economic Development of the Republic of Croatia* (CSEDRC 1992, p.26). The authors provided an illustration of how it would look, and it was expected that this illustration would be convincing. Total assets of an estimated 25 billion dollars were assumed to be distributed to five million people (the estimated population of Croatia at that time). Every citizen was to receive shares of a nominal value of 5000 dollars. Companies that were supposed to be privatised through the voucher model issued shares. The nominal price of shares was supposed to be 100 dollars and the number of shares to be issued would depend on the book value (the nominal value) of every company. It was supposed that companies might be classified according to several criteria of efficiency into five groups. Then every citizen receives 10 shares (1000 dollars) from each of the five groups, in total 5000 dollars in shares. Then begins the exchange of shares. It was explained that the 5000 dollars in shares could actually be distributed in the form of vouchers. In this case it was supposed that vouchers would be initially exchanged for shares at public auctions. The proponents of the concept were “confident that an intensive trade on the capital market would very soon transfer the dominant portion of ownership into the hands of really interested entrepreneurs” (CSEDRC 1992, p. 27, my translation and my emphasis).

The authors also emphasised the advantage of this method of distribution: “The distribution of shares is an acceptable [method] for Croatia. The advantage [of the method] is that it doesn’t require an exhausting process of the evaluation of every particular company.” (CSEDRC 1992, p. 26, my translation and my emphasis.) A number of other authors shared this view. I will quote here two who were the most active advocates of the method of distribution. Drazen Kalogjera (1992), the first Croatian minister of privatisation concluded: “All estimations of [the value of] socially owned companies, upon which thousands and thousands of German Marks were spent, unless there was a market of companies, and prices formed on it, represent a purely administrative valuation without any practical use.” (My translation and my emphasis.) An influential journalist Drago Buvac (1990, p. 99) also stated: “The capital market gives the first evaluation of social assets.” (My translation and my emphasis.)

The above conclusions followed obviously from criticism of the administrative appraisal of the value of assets. It was certainly a consequence of the unfortunate experience of administrative price regulation under socialism. Seen from that
viewpoint the arguments were persuasive. The creators of the proposal believed that intensive trade would take place in the capital market. But this was an incorrect and contradictory prediction. This is the point where the understanding of the market that was promoted by the Croatian economists fails. Intensive trade in the capital market is impossible without an intensive evaluation of the assets to be traded. Croatian economists believed that any evaluation of assets and estimate of their value before market exchange is necessarily arbitrary; and that it might be misleading and even deceptive. One can agree with this belief. Therefore, they concluded that property rights were to be distributed without any evaluation of assets. This reasoning was wrong.

The principle that was promoted was – let the market evaluate assets. They explicitly believed that intensive trade would occur. Let us consider the options that were available to the person who received vouchers or a portfolio of shares: (1) to sell them immediately to the first bidder; (2) to retain them without caring or knowing what he actually owns (3) to investigate what was the value of his ownership. The first two options will be commented upon later (chapters VI and VII). As for the third option, that the owner of the shares should investigate the value of their ownership, according to the ideas advanced by the promoters of this view, it was impossible for anybody to estimate the value of ownership before market transactions take place. The conclusion leads to an absurdity: If one owns a voucher, one would not buy shares; one would “let the market estimate the value of shares first”. Going further into this absurdity, if the assessment of a company’s shares is impossible for anyone, but it is only possible for the market, then the voucher owner will let the market buy shares. In fact, without information, market participants would themselves refrain from market transactions. Instead of the sudden emergence of a capital market and intensive trade that was assumed, the proposal “let the market do its job” led to the disappearance of the capital market. In Croatia, intensive trade on the capital market did not take place. In many countries where the voucher method was implemented, a particular fraction of voucher owners refrained from participating in the market; which fraction of shareholders didn’t participate, depended on the transparency of the market and other institutional issues.

One can say that the first wave of privatisation in Croatia wasn’t exactly a voucher privatisation. The Law stipulated that the company which applies for the transformation of ownership includes in the application an evaluation of its assets. Usually it was a book value. That was to be certified by a licensed accounting office.
But the point here is that there was a missing market. Nobody in Croatia predicted that market exchange might not take place after the initial allocation of legal property rights to individuals and if there were no legal barriers to trade. In my opinion this was a reflection of an intensive propaganda of the concept ‘let the market estimate the value of shares first” which systematically neglects market information.

In Slovenia the possibility of a missing market was explicitly envisaged and a scenario for the building of a market step by step was considered (Simoneti 1997). This was a consequence of two different understandings of the market and property rights in Croatia and Slovenia. Individuals in Croatia received shares, and their value was officially estimated but this estimation was systematically disregarded and undervalued, as it didn’t have any relationship with the ‘real’ value. The accounting offices used this very idea to reject any responsibility for the estimated price of assets that was in fact certified by them. Insufficient regulation of market information and low transparency, which accompanied privatisation, has been a standard characteristic of the market in Croatia. This approach I shall describe as a market without information. It relates to the idea of “a market without property”, that is to say the concept of a market that doesn’t take into account the costliness of property, which was analysed in Chapter III. The description of the process of privatisation in Croatia in the following chapters will show that in reality it also became a market without prices.

4.3 Macroeconomic conditions

It is reasonable to suppose that the meaning of the position “let the market evaluate assets” was actually “let the market participants evaluate assets and decide about exchanging their vouchers and shares”\(^\text{13}\). This must be the responsibility of market participants, not the responsibility of the state. Therefore, it is time to analyse the arguments against an evaluation of assets by the state before the distribution of certificates and how market information was disregarded. The statements were:

(1) It is impossible to set a ‘real’ market price for the assets to be sold (or distributed) by any method of evaluation [meaning administrative method or accounting].

(2) Because of the impossibility of setting a ‘real’ market price, the evaluation of assets might be misleading and even deceptive.

\(^{13}\) Presumably what people also had in mind was that, as a market got going, prices would reach equilibrium.
(3) The evaluation of the value of assets to be distributed in voucher auctions was unnecessary.

(4) The only method for the appropriate evaluation of assets is the capital market. (PPED 1991, p. 18)

Following the statements (1) – (4) it was usually concluded that voucher distribution is a better method of privatisation than the selling proposal; it is better to distribute ownership without the prior evaluation of assets and in some radical interpretations a voucher privatisation must be without an evaluation of assets (this follows from point 2). The capital market will evaluate assets and produce “a motivated owner”, an owner who is interested in the success of the company and by virtue of the capital market, Croatia will get adequate forms of corporate governance (CSEDRC 1992, pp. 30-31).

The impossibility of an adequate assessment of value (1) was supported by the following arguments (PPED 1991, pp. 17-18).

(a) The attempt at the assessment of a selling price for a particular company isolates this company from its business partners, its suppliers and the buyers of its products. Market success of these business partners can be decisive for the financial and business results of a company to be evaluated.

(b) High tariffs, negative interest rates (lower than the inflation rate), subsidies and other forms of stimulation of businesses under socialism also make a realistic evaluation impossible.

(c) If the aim is to appraise the discounted value of the future net income of a company, it is necessary to forecast the movement of future prices on the domestic and international markets, future exchange rates and interest rates. But this is impossible.

Croatian economists were completely aware of the necessity for reforms of the tax and tariff systems (minimisation of subventions, opening of the economy to market competition), and of the necessity for the stabilisation of monetary policy (CSEDRC 1992). This relates to point (b). It is important to note that the

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14 The first wave of privatisation in Croatia was conducted before the substantial monetary, fiscal and tariff reforms. In the years 1992/93, i.e. the first years of privatisation, the monthly inflation rate in Croatia reached 25-30 percent and in October of 1993 a powerful program of monetary stabilisation was implemented. A radical reform of the tax system was conducted in the year 1994 (personal and company income tax) and subsequently tariff reforms followed. The other countries (especially the Czech Republic, Slovenia, Hungary) transformed their macroeconomic environment before privatisation.
material to which I have been referring (PPED 1991) was written at a time of great macroeconomic instability: an intensive fall of production occurred and the rate of inflation reached hundreds of percent a year. The program of privatisation lacked an explicit link between macroeconomic stability and privatisation (the capital market). I will try to explain that the absence of this link suited the position about the impossibility of the estimation of the value of assets before market exchange.

A responsible market participant and owner of vouchers had to do exactly what was considered impossible: estimate future prices; take into account subsidies and other forms of stimulation under socialism; anticipate the performance of business partners etc. The advocates of the method of the distribution of shares assumed that it was impossible for the state administration to undertake such an evaluation, but it is not easy to understand why it would be easier for the owners of vouchers under conditions of macroeconomic instability and a high inflation rate. The impossibility of an accurate evaluation of assets, which follows from those circumstances, implies high transaction costs. The shift of responsibility from the state administration to the voucher owners doesn’t lower transaction costs. Perhaps they become even higher. I want to convey here that – contrary to all those who advocated the distribution of shares or vouchers without evaluation – the asset to be privatised must be evaluated by possible bidders prior to the auction.

If the asset was not evaluated, then the creators of macroeconomic policy that can substantially influence the value of assets (and price of capital) are freed of any responsibility for the capital market. The opponents to the evaluation of assets basically state that (1) an administrative estimation of the value of assets is impossible because of great macroeconomic instability and because of a powerful shift of the system from socialism to capitalism; (2) the market will estimate the value of assets, hence estimation is not necessary. As a conclusion, macroeconomic stability is not a precondition for an efficient capital market. If assets were not evaluated, the creators of tax policy or monetary policy could change these things while stating that it doesn’t affect the value of assets. This is an unfortunate consequence of the proposition that the asset should not be evaluated but simply distributed and left to market participants to take responsibility for the transactions. I can’t recall

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15 Stjepan Zdunic, a Croatian economist, warned of the necessity of macroeconomic stabilisation and reforms before privatisation, but his analyses about the schedule of reforms were neither further developed nor implemented during the process. See Zdunic (1998)
that the advocates of the distribution of shares without prior evaluation in Croatia explicitly requested macroeconomic stability as a precondition for an efficient capital market that enables market participants more easily to evaluate shares. In other countries it was different. The participants in the debate about privatisation in Croatia didn’t thoroughly consider the problem of market information. It was a market without information.

The decision about quick privatisation was also made under the influence of interest groups. The description of the process in the next chapter will show that the incumbent management was the most active group in the first period. Nevertheless, those who argued that any allocation of shares, even without basic preparations for a market of securities, is better than their control by the government and collectives forced the speedy allocation of shares.

5. The moral issue

It has been mentioned that a weak point of the method of selling is its vulnerability to the influence of interest groups. It is assumed that the method of distribution avoids any complaints of people that some of them were privileged and got better shares than others. This is why it was concluded that the method of distribution is a “minimally unjust privatisation”. Interest groups may ensure that the government regulates market exchange to their benefit. It is assumed that the voucher method is free of such distortions. The advocates of the distribution method didn’t provide much information on how the exchange should take place in reality. Some of them predicted that local-patriotism would be a motive for people to exchange their vouchers for shares; that is they would buy companies from their city or region; or that they would apply for shares in the companies where they worked (Buvac 1990, pp. 94ff.) It is not understandable why it was assumed that decision-making based on such information would lead to an efficient allocation of resources in the sense that was assumed by general equilibrium. The proponents of the method of distribution discussed the possibility that somebody may exchange their vouchers for the shares of a badly performing company. Their position was: if somebody loses, it was a consequence of his autonomous decision. The conception of justice that underlies the method of distribution is further explained as follows: “the poorest would sell shares and get money to enable them to have a normal life. The distribution of shares might be an instrument of social [welfare] policy” (CSEDRC 1992, p. 27).
I have mentioned earlier (chapter III, section 3.1 Market with costly property rights) that the caveat emptor principle was propagated for the Croatian stock market: once concluded, transactions of shares leave no obligations between the parties in the exchange. However, it is questionable how this principle works in the case of a non-transparent market for securities. Morality in the exchange of stocks was not considered an issue of concern: since a market without information was advocated, it was nobody’s duty to provide accurate and reliable information and guarantees for the correctness of this information; the idea of building a reputation didn’t exist; it was not assumed that insider trading might be a problem at all. In fact, the possibility that the insiders, managers and workers, (over)use their privileged position was tacitly expected as a normal development of the market. It was not thought necessary to lay down some procedure for the evaluation of the value of assets, or, indeed, to give people time during which such a procedure could take place. In my opinion, this opened a rush for resources and their dissipation, similar to the one that was described in chapter II, in the section about initial appropriation.

Moral issues could be very important for the efficiency of the process of privatisation and the further development of the market. The principle of equality and market fairness was in Slovenia conceptualised in a different way. It was assumed that it takes time to collect the information that is appropriate for making decisions about the exchange of shares. Moreover, the regulators attempted to prevent insiders from taking advantage of people in need. It is true that this affected the efficiency of the allocation of resources, not necessarily for the worse. Since the morality of the process and a sense of equality also influence the efficiency of market exchange it is only possible by an ex post comparison of different institutional structures to conclude which was economically more successful. This was explained in Chapter III.

6. Short conclusion

This chapter consists roughly of two parts. After an introductory explanation of attempts to reform self-management the first part examined the concept of property and property rights within the privatisation debate; the second part explained the concept of market that was held by the people who promoted privatisation. I argue that Croatian economists didn’t make the distinction between property and property rights which was explained in chapter III, section 1; therefore their proposals for institutional changes didn’t define clearly which
property rights were to be transferable (for example the right to residual income or the right to control and manage resource). Croatian economists didn’t propose the creation of market institutions because they neglected the insight that the institutional form of a market depends on the right that was to be transferred (and on attributes of assets). However, at the end of the day market participants decide which rights were to be transferable and under which institutional conditions, but Croatian economists didn’t even open discussion about this problem.

Croatian economists were divided on the question whether self-management represents private ownership or public ownership or if it was nobody’s property. Thorough analysis of this disagreement showed that the discussion failed to answer clearly the questions that were raised at the beginning of this chapter: What structure of market and property rights was to be achieved? What did those involved expect that a privatised economy would look like? In my opinion the answers were absent and disputants disagreed whether social ownership was private or public because it was neglected that property rights represent the power to capture income from a resource; or in Coase’s words “what [the owner] in fact possesses is the right to carry out a circumscribed list of actions”. Self-management was a form of collective ownership; it could be efficient only if the assignment of rights to individuals is too costly. In the middle of the 1980s it was definitely concluded that the costs of collective control of resources were too high. Privatisation was proposed, which meant an assignment of property rights to individuals, but it was not articulated which rights were to be allocated.

The right to capture income from resource, management rights and the right to control a resource were - under the system of social ownership - clearly divided between the state, the local community, and individuals (employees and managers). Discussants in the privatisation debate understood ownership implicitly to be a unified bundle of property rights, if the question was addressed at all. Since disputants didn’t discuss the possibility of the division of the bundle of property rights, they didn’t address which property rights were to be transferable; accordingly they didn’t develop market institutions appropriate to transferable rights. They considered property as absolute, and not dynamic; i. e. it wasn’t taken into account that property rights develop depending on the attributes of assets, costs and benefits.

Those who considered social ownership already to be private assumed that the decision on the transformation of property rights belongs to private owners
(employees). This privatisation proposal was called the method of “coexistence of social and private ownership”. This method exposes collective ownership to tunnelling; i.e. the pulling out of assets from a collectively owned company into a private one at the expense of collective owners. The theft of collectively managed assets was already recorded under socialism and this was one of the arguments that social ownership was in fact no-ownership.

Though widespread and generally accepted, the no-ownership characterisation of self-management was never and nowhere thoroughly elaborated. A key argument of those who considered social ownership nobody’s property was the restricted transferability of the right to use the flow from the company’s income. A restricted transferability of property rights was recognised by those who characterised self-management as already private ownership. They proposed only a gradual relaxation of the transferability of property rights and opposed the possibility of radical deregulation of the capital market. It seems that they were afraid that self-management wouldn’t withstand competition if markets were deregulated.

No-ownership rhetoric might be understood as a request for an immediate and radical change of the regime of property rights. The privatisation of nobody’s property implies an initial appropriation. It divides individual property on the one side and all other property arrangements on the other side. The proposal that socially owned assets should be distributed without evaluation fits into the no-ownership rhetoric. Since it was nobody’s property nobody claims that it has any value. It might be initially allocated as if it was a lottery. It was considered minimally unjust privatisation. An intensive exchange of property rights was expected. This assumption was wrong, since intensive trade requires high transparency and a developed system of information. The consequence of distribution without evaluation was a market without information; the acquisition of valuable property was left to insiders. As for the moral aspect of privatisation, the vouchers (lottery tickets) that were to be distributed were understood as an instrument of social policy.

A description of the processes of privatisation in Croatia (chapters VI and VII) and Slovenia (VIII) follows. The processes are divided into two periods: initial allocation of legal property rights and the period of exchange of property rights on the financial market. The development of financial markets distinguished the processes of transformation of the property regime in the two countries.
Chapter VI
The Process of Privatisation I

This chapter and the subsequent one describe and analyse the process of privatisation in Croatia. The subject of this chapter is the initial allocation of legal property rights to individuals and organizations. Since initially what was allocated were financial rights, the focus of the next chapter will be on the development of the financial market. My hypothesis is that the very nature of the Croatian financial market and the theoretical understandings of property and markets as described in chapter V on the privatisation debate were favourable to the emergence - from self-management (a form of collective ownership) – of a structure that was characterised by majority individual shareholdings. I will examine this hypothesis by way of a detailed analysis of the transformation of the property regime. However, the explanation of the process of privatisation will rely on insights developed within the economics of property rights. I would like to remind the reader that the economics of property rights criticised the classical approach for neglecting the fact that economic activity is organised in different ownership structures and for not being capable of explaining why distinct ownership forms emerge.1

This chapter mainly analyses the effect of the allocation of legal rights upon residual income (shares); it also explains what was different from the previous system of organisation of business activity and what remained similar. The destiny of the management class, which forced the changes of the property regime under socialism, is described in a section about the management buy-out scandal. The full significance of this scandal is difficult to capture without the context of the event. This is why statistical details about the privatisation process and its political circumstances are provided. A brief theoretical comment and an overview of the first phase of privatisation which sets the scene for secondary privatisation concludes this chapter.

1 I would like to quote again Barzel (1989, p. 9): “In the Walrasian model, where prices are sufficient for efficient allocation, institutions are superfluous; firms, clubs, tribes, or families cannot enhance efficiency.”
The introduction of self-management in 1950 signalled an abandonment of the system of central planning. For four decades, self-management and social ownership had been reformed continually. The idea of privatisation represented an attempt at a radical break with the past. For the purpose of a more comprehensive understanding of the institutional changes that will be described below I would like to recall Libecap's systematisation, which was presented in chapter III, of the factors that affect the outcome of a transition from an old to a new institutional structure. These factors can be reduced to two: (1) the characteristics of the parties that claim rights to the assets to be allocated and (2) the characteristics of assets to be allocated. Libecap concluded that the transition is easier if the expected aggregate gains are larger, and if the number of parties and their heterogeneity are smaller. What Libecap predicted happened in Croatia: for the purpose of easing the problems of transition, side payments to potential losers were used.

Bearing in mind Libecap's insights this chapter describes the assets that were allocated in the first phase of privatisation and the pattern of allocation; the arguments of the interest groups that requested their share are explained; the conflict between the old and the new political elites is described; the character of the political regime and the capability of the administration for such an undertaking are analysed. Let me initially introduce the periods and phases of transformation of the property regime in Croatia.

1. Periods

The process of privatisation in Croatia might be divided into three main phases: from 1990-95; from 1995-2000; and after 2000. This determination of the periods follows political changes that took place during this period. In 1990 the first multiparty elections in Croatia were conducted, and a year later Croatia declared its independence from Yugoslavia. In 1991 the first Croatian Law on the Transformation of Social Ownership was introduced. Then the war in former Yugoslavia started², which was - from January 1992 when frontlines

² The war in Croatia was one in the series of armed conflicts on the territory of the former federal Yugoslavia. First came an attack of the Yugoslav Army on Slovenia, after its declaration of independence from the Federation. Croatia declared its independence on the same day as Slovenia. The Yugoslav Army withdrew from Slovenia but supported ethnic Serbs in Croatia against the new Croatian Government elected in multiparty elections, so the war in Croatia was partly an ethnic conflict. The Army of former socialist Yugoslavia came under control of the last Serbian socialist leader Slobodan Milosevic, whose power was transformed into dictatorship. He finished up in the International Criminal Tribunal for the Former Yugoslavia, accused for war crimes, where he died in custody waiting for the final verdict. Further conflicts broke out in Bosnia and Herzegovina where people suffered the most, then in Kosovo and on the Macedonian border with Serbia and Kosovo. Finally, all former federal units declared independence.
were predominantly stabilised - a conflict of low intensity, and privatisation went on. In 1995 the war in Croatia ended, and an agreement that was reached signified a substantial change of the general political environment. Since during the war the Law of the Transformation of Social Ownership was amended several times, for economic reasons and as a consequence of concessions given to various social groups, in 1996 - following a broad parliamentary discussion - a new law on privatisation was promulgated. As for the third period, the authoritarian ruler of Croatia from 1990, Franjo Tudjman, died in 1999; his party, the HDZ (the Croatian Democratic Union) lost the subsequent elections and a coalition of six parties took power, leading the country into political and economic reforms.

Beside this formal periodisation my purpose was to argue that there were substantial distinctions between the phases of the process. The first phase was for the most part a period of the administrative transformation of the property regime and the time of the implementation of the Law inside companies. Below I will provide a brief formal description of the Law of Transformation of Social Ownership, statistical data about the privatised companies, and about the number of shareholders and the allocation of equity that indicate what was going on at that time.

In my understanding, the essence of Croatian privatisation came into view through significant events and developments on the financial market in the second phase of privatisation. Transactions concerning the shares that were allocated in the first phase had already started before 1995, but they were especially intensified in the second half of the 1990s. In some countries this phase of transactions was called a secondary privatisation (Błaszczyk at al 2003). These transactions predominantly led to the concentration of ownership rights (where this took different forms: individual majority owner, strategic foreign investor, control of a company in the hands of a group of managers and so on). Croatian economists called this process a search for “an active investor”. It was explained in the previous chapters that this inclination to favour an owner who controls an entire bundle of property rights was partly a consequence of dissatisfaction with a collective nature of social ownership and self-management; on the other hand, a non-transparent and chaotic market

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2 The Dayton Peace Accord is generally known as the agreement on peace in Bosnia and Herzegovina (a neighbouring country) but this document about regional stabilisation was de facto signed by the conflicting sides in Croatia.
for securities was favourable to such an ownership structure. The quality and outcome of this process heavily depended on the characteristics of the capital market.

Until 1995 the Croatian market was – due to understandable circumstances – heavily deformed. At that time, most of the people somehow tolerated strong political control and interventions by the administration into the process of privatisation and economic affairs more generally. The characteristics and the design of the financial market, especially after 1995, were much more destructive for society than merely that there was an untidy initial transformation of ownership. The thesis that markets simply require an appropriate legal system for the enforcement of property rights and then exhibit ‘spontaneous order’ which need not be designed was tested in the Croatian case. After the initial allocation of ownership, the succeeding events were neither spontaneous nor simple at all. The Croatian case - if viewed either in the light of the economics of property rights or of what took place in Slovenia - suggests that fair and transparent competition should have been organised and that the institutions needed for the successful operation of a market for securities should have been rationally created. It doesn’t imply that the market for securities must be organized by the government. It simply means that the creation of an efficient market is a conscious activity. It could be called “an appropriate legal system”, but Croats failed to proceed in this way. The secondary privatisation is the subject of chapter VII.

Finally, concerning the third period, in the concluding chapter X I will briefly describe how (and why) the government after 2000 developed the capital market artificially and forced companies to become more transparent. I believe that the Croatian experience of economic transition provides new understandings of the relationship between privatisation and the introduction of a market economy; as to what the relationship between modern private property and a developed

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4 The idea that privatisation should create a controlling shareholder, a responsible owner who has the power to restructure the company, was recommended by the World Bank (Cengic 2001, p. 33). Among Croatian economists it was also considered that an increase of efficiency was not possible without the concentration of ownership (Rohatinski, Santini, 1994, page 17). It was explained in chapters II and III that a necessary request for property to be understood as private was that the consequences of decisions fall on a decision maker, and it was concluded that the structure with a dominant shareholder satisfies the criterion (Alchian 1997). The methods adopted to achieve that goal in Slovenia and in Croatia were different as well as the results.

5 However, this understanding of spontaneous order should be distinguished from Hayek’s investigation of spontaneous development of an order. Hayek criticised the general equilibrium understanding of market which is here the unquestionable principle.
financial market consists of; what private property actually amounts to today and what its significance is for contemporary society.

2. The first phase

Privatisation in Croatia started while the country was still part of the former Yugoslavia. The ideas of orthodox socialist economics were finally overcome in the second half of the 1980s, and some legislative activities were undertaken: private companies were allowed, also a combination of social and private ownership, and particular forms of foreign investment (Uvalic 1992, p. 176). Finally, in the twilight of Yugoslavia (and in the dawn of an independent Croatia) the Law on Privatisation (LSC 1990) was adopted. Companies were allowed to issue internal shares, initially not tradable on the stock exchange (which at that time didn’t even exist). Trade concerning those shares was restricted to transactions between employees of the companies in question, but under some conditions shares were convertible for debt. Internal shares gave the right to participate in after-tax profit and in management. The federal units of Slovenia and Croatia suspended the Law on their territories even before their independence. Problems with the implementation of the program were noted; Croatian economists complained that the federal program retained too much self-management (PPED 1991, p. 77). Slovenian economists concluded that the process opened the opportunity for pulling assets out from the companies (see chapter V on tunnelling). In fact, both countries wanted to control privatisation on their own territories, believing that the process must be adjusted to the specificities of their economies. However, some Croatian companies, following the Law, speedily issued internal shares, a process that was later subject to verification by the responsible governmental agency. The Croatian law on privatisation (LTSO 1991), which referred exclusively to companies with headquarters in Croatia, passed legislative procedures in the Parliament of the Republic of Croatia on April 22, 1991.

In the first phase of privatisation the Government selected 3619 companies for transformation of their ownership regime. The total value of those companies was assessed to be more than 30 billion Deutsch Marks (at that

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6 The Law on Social Capital, Yugoslav Official Gazette No. 46, 1990

7 This assessment was made by a licensed accounting office on the basis of the book value of companies’ assets. Nobody regarded these assessments as relevant market information; quite the contrary, it was often and rightly despised as a bureaucratic endeavour. However, this doesn’t imply that privatisation should have been conducted without the transparent assessment of assets (see chapter V, sections 4.2 and 4.3).
time around 15 billion euros, and today, due to inflation, certainly much more). Excluded from the Law were Croatian ports and marinas, agricultural companies, the oil industry, banking, insurance, shipbuilding companies, the health industry, education, housing, road and railway transport, the telecommunication industry, the energy sector, the water industry and communal services (Cuckovic 1998). The explanation for the exclusion of these industries from the first wave of privatisation was their strategic importance and the high uncertainty of the effects of their privatisation. Some of these industries and utility companies were privatised later, following the passage of laws designed particularly for these companies or industries.

2.1 The design

The management of each company was ordered to prepare a program of transformation before the end of June 1992 (14 months), following the requirements stipulated by the Law. The program was represented as “controlled, decentralised privatisation”. A state agency was the controlling institution.

The process was designed to work as follows: the company issues shares; employees had priority in the purchase of these shares, being granted a basic discount of 20 percent plus 1 percent for every year they had worked in the company. This implied that the rights of employees from the period of workers’ ownership were recognised; also the discount was designed to attract employees and accelerate the process. The opportunity qualified to buy shares at a discount was given also to former employees. Every employee and former employee was limited in the purchase of discounted shares to the amount of a maximum of 20,000 Deutsch Marks. After the employees’ shares had been allocated, all other citizens, employed in companies that were not selected for privatisation and in the state administration, were given the chance to choose a company from the list and to subscribe for its shares at a discount. The explanation was that otherwise they would be deprived of the privileges given to employees of companies selected for privatisation. This was explained by the idea that all citizens participated in the creation of socially owned assets. The most important rationale was the belief that if all citizens were given the opportunity to subscribe to shares, this would accelerate
privatisation.\(^8\) Employees of the company and other employed citizens were given the possibility to pay for their shares over five years (later this period was extended to twenty years).

The proportion of shares sold at a discount (to employees and other citizens) was limited to 50 percent. The idea was to leave a controlling percentage of shares to a possible strategic investor. This stipulation was the first official signal that an ownership structure with a dominant shareholder was favoured. Management was allowed to include in the program of privatisation of a company an outside strategic investor, whether by selling the remainder of shares or by accepting further investment and an increase in capital. The Law opened the possibility that companies, with the agreement of banks and other creditors, could re-organize their debt as equity.

The process was strictly controlled by the Agency, which was also responsible for selling the remainder of the shares. Management was obliged to include an evaluation of assets in the program (it was usually made by a qualified/licensed accounting office) and also a program for further development. The unsold shares were transferred to the pension funds and the Agency for the Development of Croatia (later, the Privatisation Agency), which was controlled by the Government.

Privatisation was conceptualised as an autonomous process, controlled by a responsible public institution. Very small companies, where capital was estimated to amount to less than 5 million Deutsche Marks, weren’t obliged to wait until the Agency had certified their program. Employees had priority in the process of subscription and in buying shares. The discount was interpreted as a form of distribution of shares. The average discount was 35 percent.

Management was obliged to prepare a business plan, a program of development and to reach an agreement with creditors or potential investors. The design of

\(^8\) At the end of the 1990s a scandal erupted when it was found that about 9000 citizens (government officials among them and a number of members of the ruling party) used the privilege of deferred payment and discount and subscribed for more than one package of shares of an amount of 20 000 DM. This was not explicitly forbidden. Those who subscribed explained that they were even encouraged to do this and accelerate privatisation. The opposing side argued that the reason for the discount was the recognition of earlier contributions in the creation of social capital. Consequently, one employee/citizen has a right to one discount. It was a conflict between the principle of equality and the effort to accelerate privatisation, but I think it was more a political battle against the ruling party. Some officials subscribed for several packages and presumably they had access to banking loans to finance their investment, while other citizens didn’t. The practice of banking in privatisation will be explained later. The reference for this theme is Cengić (2001)
the process was a kind of compromise between the two methods of privatisation that were described in the previous chapter: distribution and the sale of socially owned assets. It was also an initial compromise between the interest groups: workers, management and political institutions. Citizens got the opportunity to participate. Sensitive assets were excluded from privatisation during the first period, while different discounts and privileges were employed to attract as large a segment of the population as possible. The management was given reasonable autonomy in taking part in the process. A significant percentage of assets was in fact distributed.

2.2 The results

Let us immediately look at the results of the first phase of privatisation. The Agency certified the programs of privatisation of more than 2.5 thousand companies (of the 3.6 thousand candidates for privatisation) in a very short period and their transformation was completed swiftly: 1,120 companies were privatised completely, 1315 companies ended up with majority private owners and 108 companies finished in the hands of state owned funds. Almost 600,000 individuals subscribed for shares at a discount. This at first sight looks impressive, concludes Nevenka Cuckovic (1998, p. 190) in her doctoral thesis.

Cuckovic, together with other analysts (Rohatinski and Santini, 1994, p. 23), criticised the process and outcomes of the beginning phase. The essence of their criticism was that the process of privatisation was slow. Instead of a maximisation of the percentage of privatised social equity, which was recommended by a majority of Croatian economists (CSEDRC 1992), commentators concluded that the hidden goal of the process was to collect money for the central budget. This implies that the change of property regime wasn’t a priority. Critics claimed that it actually amounted to the nationalisation of social ownership and that it signified a regression in comparison with the previous decentralised property regime.

Some figures, supportive of this criticism, were offered. The nominal value of the 1120 completely privatised companies was only 9 percent of the total

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9 For 90 percent of people privatisation was a method to protect their employment. So they expressed their loyalty to companies by subscribing for shares. Also, they were persuaded that companies that were privatised and not any more under the influence of political decisions, would have better performance, so their jobs would be better protected. (Cuckovic 1999)
capital ordered to be privatised. Of the remaining 91 percent of the capital, the Government retained majority or minority ownership. It was claimed that in both cases the Government significantly affected business behaviour. At the end of 1992, the Government controlled 60 percent of the capital of companies selected for privatisation, subsequently that fraction decreased to 45 percent. According to the Transition Report published in 1997 (most of figures were collected in 1996), the fraction of the private sector to GDP was in Croatia around 55 percent, while in other relevant countries it was usually much higher: Czech Republic – 75 percent; Hungary – 75 percent; Poland 65 – percent; Slovakia 75 percent, Romania – 60 percent, but Slovenia only 50 percent (TR 1997).

Cuckovic (1998) concludes that the goal of raising money for the treasury also wasn’t fulfilled, because employees (and not outside strategic investors) showed the strongest interest in shares; at the same time, employees received a significant discount and made their purchases in instalments. However, the claim that not enough money was collected was an attempt to force the Government to privatise the assets remaining under its control. Unlike other countries in transition, especially the Czech Republic and Hungary, foreigners from the West failed to invest in Croatia, presumably because of the war. In the first five years, only two percent of the central budget cash income came from privatisation proceeds. Later amendments opened the possibility that shares could be purchased using state bonds, and proceeds from this source were three times higher. This repurchasing of state bonds decreased the financial obligations on government to service its debt. Calculating this into government income, about 8 percent of central budget revenues was collected from privatisation in the period 1991-1996 (Cuckovic 1998, p. 191).

In fact, it was always possible to confront the figures that were provided by the critics of the process with the interpretation that the results weren’t so bad. Slovenia was usually assessed the best transitional performer, but the percentage of private ownership in its economy in the middle of 1990s was even lower than in Croatia. The fact that 15 percent of the total Croatian population took part in privatisation might be interpreted as impressive. Also, when individual shareholders, mostly employees, stopped paying their instalments before they had fully paid for their shares, the term was extended to 20 years (from 5). This decision was explained by saying that its purpose was to make shareholding more attractive to employees. The Government was very strongly devoted to retaining
as many individual shareholders as possible and to creating further shareholders of this kind.¹⁰

The thrust of criticism like that made by Cuckovic was to emphasise the point that the process of privatisation was actually nationalisation, and that the formerly self-managed companies finished up in the hands of the state. I think that it is not possible to support this conclusion by providing purely economic figures, though that was a common approach adopted by various international institutions that assessed the progress of transition. The reason is that economic figures don’t express comprehensively the character of the new property regime. It will be explained in the concluding section that even companies that were formally privatised were under the strong influence of the political authorities. In the 1990s Croatia was actually an authoritarian state and this was reflected in economic relationships and in the character of economic property rights over companies. I will now provide a brief description of the nature of the political regime in Croatia; I will also explain how the character of the political regime was reflected in the process of privatisation.

³. Authoritarianism

International analysts usually considered the Croatian political system of the 1990s to be an authoritarian regime. Croatian political scientists concluded that international analysts used the term autocracy, when the description of Croatia was an issue, improperly, in fact to signify a mix of elements of a totalitarian system and democracy. The other terms used for the description of the Croatian political system, were: elective dictatorship, illiberal democracy, defective democracy, authoritarian-populist regime, a nationalistic-populist regime (Kasapovic 2001, p 17). When progress to democracy was assessed by international organizations, Croatia was usually very close to the bottom of the lists. Improvement was not noted even after the end of the war (1995), until the death of President Franjo Tudjman in December 1999.

¹⁰ The destiny of small individual investors will be discussed later and what the purpose and the outcomes of the government’s favouritism of small investors were. It seems that the extension of the term to pay for shares wasn’t what they expected from privatisation. Many of them stopped paying their instalments so almost sixty percent of contracts (350 000) between the Croatian Privatisation Fund and small individual investors were terminated by dominant shareholders by the end of the 1990s and the shares were returned to the ownership of the government. I will show that their disappointment was a consequence of the design of secondary privatisation (the financial market).
The criteria used in such assessments were not very clear: for example, whether Croatia was unfavourably positioned due to its undemocratic institutional arrangements or because of the behaviour of the main political actors. As for the fundamental institutional arrangements, the analysts (e.g. Kasapovic 2001, p. 19) assessed the Constitution of the Republic of Croatia to be satisfactory: basic human and democratic freedoms were guaranteed. But even the institutional arrangements lacked some necessary democratic qualities: a system of checks and balances among the main political actors was not enforced, while political power was in the hands of the President of Croatia. The Parliament and the Government were legislative and executive services of the President. The President governed arbitrarily. As for the behaviour of the main political actor(s), public policy was characterized by ethnic intolerance and the infringement of minority rights and human rights; the politicisation of religion and clericisation of politics, corruption, nepotism, favouritism, clientism in political and public life, party control over the media and financial pressure over independent, private media, and political control over the judiciary. The intelligence service was used against political competitors of the party in power, and for the surveillance of independent journalists and public intellectuals (Kasapovic 2001, pp. 21-22).

This was the general assessment of the Croatian political regime of the 1990s. The question is how it was reflected in the privatisation. Again I shall follow two lines of approach. The first concerns the legal arrangements that opened possibilities for the intervention of political authorities in corporate matters; the second point was the regime’s privatization policy. That was to amount to clientelism and populism (Kasapovic 2001, pp-22-23). The question that synthesizes both was how those legal arrangements were used to give advantages to a people close to the leading party or to party members.

3.1 Privatisation and Authoritarianism

The dissonance between the process of privatisation in Croatia and the basic principles of liberal democracy is easy to identify in the documents, though in Croatia not enough academic scrutiny was devoted to this problem. It was more a subject of investigations and protests in the popular media. I will note some critical examples.

(1) The most important preconditions that ensure that a democratically elected government also rules democratically are legal constraints on the power of the
administration. Civil government must be limited in two ways: “It was to be limited by being subject to, and not above, the law; and it was to be limited concerning the extent of human affairs over which its authority could legitimately be exercised” (Oldfield 2000, p.6).

Neither of these two limitations\textsuperscript{11} was consistently respected in the key Croatian laws or the directions given by the Croatian Government concerning privatisation. I have already mentioned that the process of transformation of the property regime started while Croatia was still part of the former Yugoslavia. Just six months after winning the elections, the Croatian Government issued a Direction about the Protection of National Interest (DPIR 1990), which gave the Minister of Justice the power to intervene in the process of the transformation of social ownership that was already underway. The Direction obliged companies to report their intentions concerning privatisation to the Minister of Justice, after which the Minister would issue permission to continue the process of privatisation. Proviso 4 of the Direction literally specified the Minister’s right to “free assessment” as to whether the national interest was endangered or not. Hence, there was no law, no criteria as to what “the protection of the national interest” meant. The same stipulation explained that a company could complain to the Government, but that the Government’s decision was final: no appeal to a court was possible. The Direction explicitly stated that foreign investment and investment by parties outside the company was suspect in the transformation of ownership.

(2) The abovementioned Law on the Transformation of Social Ownership (LTSO 1991) that passed the Croatian Parliament in April 1991, just a few days before the first armed conflict in the war in Croatia, had the same character as the earlier Direction. This time the power of the Agency for Restructuring and Development (later the Agency for Privatisation) was not subject to the law. The Agency had the right to intervene at will in the activities of the firm and to violate the firm’s autonomy (stipulation 42), so the private domain was unprotected from arbitrary activities by the government.

The Privatisation Agency was given the right to intervene in successful and profitable firms, and intervention didn’t have to be related to privatisation: Proviso 42 permitted the Agency to act even in the case of a simple argument among employees (in the case of “upset relations in the firm”). Even if what these

\textsuperscript{11} These limitations originate from the liberal tradition of John Locke and his endeavour to limit absolute monarchy (Two Treatises of Government, Everyman 2000)
powers were exercised over was not the private domain in the sense of personal property, it was clearly the non-state domain, which was affected by this proviso. It was a legalized autocracy. Even if we understand the heated atmosphere in Croatia at that time, that doesn’t mean that discretionary power to act without criteria should have been given to the Government.\(^\text{12}\) Actually, the proviso had the effect of exercising discipline over executives across the companies, and pressured them into informal submission and the formation of alliances with political actors. The Agency intervened in firms where management wasn’t obedient.

4.1 Privatisation and the executives, the buy-out scandal

The above description of the first phase of privatisation, its design and results, and the note about the political system are necessary to set up the context for the analysis of the key characteristics of the process of the transformation of the property regime. In the chapter about self-management it was shown that the new classes - the professionals, managerial and technocratic class - emerged during the decades of expansion and economic growth, from the 1960s onward. That was a consequence of the changed mode of production and the changed nature of industry (economy).

Under socialism, the managerial class didn’t formally hold assets. It occupied ruling positions in companies, and also some prestigious social and administrative positions. From these positions the elite managed capital and technology and organised social and political activities. The company-executives were in 85 percent of cases members of the Communist Party. Two surveys conducted in 1984 and 1989 showed how the preferences of the elite toward privatisation were changing. While in the first survey only 7.6 percent of them favoured private property, five years later 68 percent were for privatisation (Kristofic 1999).

\(^\text{12}\) Croatia didn’t conduct a formal lustration of the former communist cadre like some other countries did (the Czech Republic, for example). Therefore it wasn’t specified who “the enemies of the people” were, but campaigns against them were very strong during the 1990s. This is probably why the abovementioned stipulations aimed at “the protection of national interests” weren’t criticised in academic circles or in the media. On the contrary, the popular media sometimes stimulated the policy of ideological purity. Some bizarre cases were a consequence of the absence of formal lustration. Vinko Sindicic was a member of the Yugoslavian secret service who attempted to kill the Croatian dissident Nikola Stedul in 1988 in Scotland. Sindicic was jailed for several years in the UK. In the year 2003, as a free man, he attempted to buy a hotel company. After public anger this deal was cancelled, though it was legally perfectly clean (except that nobody knew where Sindicic’s money came from). In this atmosphere of ideological (national) purity the Government easily got support for selling the leading daily newspaper Vecernji list - as a nationally sensitive asset of a kind - to a group of trustworthy businesspeople whose joint company was hidden in an offshore tax oasis.
question is what role in the transformation of ownership rights the executives of the companies saw for themselves.

The law stipulated that the executives should prepare the program of the transformation of ownership, discussing it with creditors, business partners and potential strategic investors. The law didn’t suppose that the management was in a privileged position in comparison to the other employees. However, their position in reality was privileged. The executives also took an active part in the process beyond the role that was stipulated. One consequence was the first big privatisation scandal in Croatia, i.e. the management buy-out scandal of 1992 (which is explained below). It finished up in Parliament where a special law against so-called management loans was enforced in 1993. This scandal also anticipated further events on the capital market in Croatia after the initial allocation of ownership. I will here firstly provide a brief description of this affair and then offer a short comment.

Soon after the Law on privatisation passed, the banks offered the executives of companies very favourable loans for buy-out shares in their companies from the quota beyond the shares that were supposed to be subscribed for discount. As a deposit for these loans, banks accepted personal “frozen deposits”13 and managers’ personal insurance policies that were paid for by the company as a part of the management contract. The collateral for these bank loans were shares: if the manager did not pay his instalments on time, the shares would belong to the bank. It looked as if management loans were a winning combination: the process of privatisation would be accelerated; the liabilities of the treasury regarding the frozen deposits would be decreased; the banks would utilize state bonds, and their partner companies would get a final and stable ownership structure. Also it would have launched the market for securities.

This last point was the problem: the executives were insiders on a market that lacked transparent regulation both informal and formal. The transformation of

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13 It must be explained what “a frozen deposit” was. After the dissolution of former Yugoslavia the Croatian banking system and the banks weren’t able to pay off on request personal deposits nominated in foreign currency any more. The Government of Croatia issued ten years state bonds for a restructuring of the banking system. Every bank had received bonds at a level adequate to the amount of personal deposits “frozen” in the bank. Every six months the Government used to pay 5 percent of the bond’s value so the banks could release a corresponding amount of personal deposits. People who owned the frozen deposits were allowed to exchange them to buy shares or socially owned apartments. Because the proceeds were going to the treasury, this exchange of frozen deposits for shares decreased the liability of the treasury toward the banks.
these self-managed companies into joint stock companies was a kind of initial public offering (IPO), but without a regulated stock exchange. The executives were able to affect the estimation of the value of shares in this initial offering. Suspicions were raised that some executives intentionally led some companies into losses in the last year before privatisation (Cengic 2001, p. 140). This decreased the value of stock so that they had the opportunity to acquire it for a lesser price. In some cases the members of the management board would collectively establish a separate company, and backed by banks would compete for majority ownership in the original company. The banks issued 18.5 thousand management loans, what is a pretty high figure, bearing in mind that 2.5 thousand companies formally transformed their ownership (Cengic 2001). This amounted to 7.5 management loans per company (on average), which would be quite enough for a takeover, especially if the executives had at least minimal support from the employees.

The main objection to the management loans was the inequality of the starting position: the executives enjoyed a great advantage over the other employees. Actually, some banks offered a similar scheme for employees following the experience of employee stock ownership programs in the USA. However, the executives had an informational advantage; they inherited very good relations with the people from the banks and the administration already from the period of socialism, they had personal insurance policies (paid by companies) to invest as collateral for loans and they had higher savings deposits (frozen) in the banks.¹⁴

When the phenomenon of management loans became public, it raised anger predominantly in political circles. The phenomenon of the management loans didn’t stimulate discussion about the regulation of financial markets (the idea of self-regulation was deeply entrenched), but a battle over influence upon companies erupted. This showed how important privatisation was for the entire transition and for the Croatian politicians. The ruling party split into two camps, the technocrats and the hardliners, the latter group declared themselves primarily to be anticommunists and nationalists. The technocrats,

¹⁴It is important to remind the reader here of the character of the deposits. It was not that executives invested their savings. Actually, their savings in banks, just like all other such savings, were lost in the banking collapse. The existence of the frozen deposits was enabled only by contributions which came from taxpayers. Therefore, people were suspicious of the manipulation of securities that were a product of their activities, indeed, of the activities of those who didn’t have deposits and those who held a significant amount of ‘frozen’ deposits. However, from the point of view of the entire economy investment of frozen deposits in companies, taking risk and releasing the treasury’s liabilities was in fact quite a pragmatic policy.
who supported the management buy-out scheme, insisted that nothing was
done against the existing law; although they acknowledged that the scheme was
“morally suspicious”. They insisted that the rule of law, which was neglected
under socialism, must be respected. Therefore they accused the hardliners of
repeating the communist practice of not respecting the law. The hardliners
claimed that the management loans were provided predominantly to “the old
communist cadre” and that the scheme was preserving an inefficient self-
management structure. The hardliners won the battle in the Parliament and
the Law on Cancellation of Particular Contracts (the management loans) was
enforced. This Law was so complex and in conflict with some laws that actually
almost none of the more than 18 thousand management loans was cancelled
(the above description is based on Cengic 2001).

Both the politicians and the ordinary people conceived the conflict about
the management buy out scheme as a battle between the old management
structures inside companies and new people, who expected to be politically
appointed to executive positions. Similar conflict has been noted in other
transitional countries. Both sides accused the other of communist practice.
While technocrats were accused of belonging to the old elite, the hardliners
were accused of behaving rigidly and as communists. In the course of testing
two theories, the first about the replacement of the old communist elite in
the transition (that was favoured by the hardliners) and the theory of the
continuity of the elite, Croatian social scientist Kristofic (1999) has noted: “Of
130 managers who were surveyed in 1996, 60 had also been directors under
socialism, and 70 came to their management position after the change of the
government.” Two thirds of all of them weren’t members of any political party;
half of the new executives (35 of them) were members of the ruling party. It
is sensible to suppose that they achieved their position thanks to the fact of
their party membership, especially having in mind that, according to surveys,
new executives were on average less educated (and certainly less experienced)
than old managers. Kristofic concludes that:

The old directors made [after 1990] greater use of the position they had
acquired in the times of socialism, whereas the new managers used the political
position they achieved in the new system more frequently. Some have, of course,
combined both types of political opportunity. In their efforts to keep or acquire
power, both behaved pragmatically. The process of formation of the executive
class in the conditions of transition, at least in Croatia, can be explained neither
by the theory of the replacement of the elite alone, nor by the theory of the survival of the elite. Both these theories receive the same support from our data. The data also show that in the game of keeping and/or acquiring management positions, knowledge was the least important factor. Therefore the theory of technocratic continuity can hardly be sustained in Croatia.\textsuperscript{15}

Kristofic as well emphasises support from the majority of the population for the hardliners’ nationalistic policy.

\section*{4.2 The preferred groups}

The original Law on the Transformation of Ownership was amended six times in the Croatian Parliament from 1991-1995. These changes generally had two directions. The first was to limit the power of insiders (after the outbreak of the management scandal), hoping that this would attract outside investors; it was mostly expected that rich people from the Croatian Diaspora would like to invest.\textsuperscript{16} Investors from Western countries who were considered influential in their countries were also welcomed, since it was expected that they might help the legitimation of the regime of a newly independent country. The Government was also oriented to creating further individual shareholders. The amendments enabled the distribution of shares to people who had suffered in the war – to war veterans, to the families of victims and to former political prisoners.

Such moves were always supported by a moral justification. Employees were given the opportunity to buy shares since “they created those assets”. Former political prisoners emphasised that they didn’t have the chance to work in companies “while they fought for freedom”; therefore they demanded their share. The inclusion of the victims of the war among those who were supposed to benefit from privatisation was justified by the principle that the redistribution of national wealth should not leave anybody to starve. I would like to recall that the moral arguments that were raised in Croatia were similar to the arguments about initial appropriation that were discussed in chapter

\textsuperscript{15}I would like to say that the theory of the continuity of the elite counted on its skill and experience inherited from socialism and pragmatism in transition. The proponents of the theory of the replacement of the elite believed that in new times people who are not burdened by socialistic habits have a higher chance of success. It seems clear from Kristofic’s analysis why neither one of these theories fits Croatia.

\textsuperscript{16}Sime Prtenjaca, the head of the County of Dalmatia, concluded about the interest of the Diaspora in investing in Croatian companies: “Our people who earned money abroad ... don’t want to bother with a number of individual shareholders. This is a golden rule for them. They want to have total control over invested money.” (Privatisation No. 17, May 1996, my translation).
II. The suspicion, which was advanced in chapter II, as to whether it is possible at all to find an uncontroversial moral justification of initial appropriation, here was strengthened by the fact that these moral justifications conflicted: the arguments of former political prisoners, employees and others were in fact persuasive, but it wasn’t possible to fulfil all of them. However, it doesn’t imply that the moral assessment of the process of privatisation was inappropriate. The economic aspect of this problem should be emphasised: If privatisation should not leave anybody to starve, is a distribution of resources, more specifically, shares the best method to implement this principle? This problem will be additionally commented on below, but here I would like to recall the position of Croatian economists, which was mentioned in chapter V. In the already quoted Conception and Strategy the Croatian economists proposed that the transformation of the property regime should respect the principles of social justice. It was assumed that the method of the distribution of assets, or giving a big discount, would enable “the poorest people to collect money for a normal life”. The distribution of shares and their subsequent sale would be an “easy solution of social problems” (CSEDRC 1992, p. 27).\footnote{17} This confirms that Croatian economists provided a theoretical argument for the distribution of assets to chosen social groups.

It was noted that the distribution of shares was also politically motivated. Kasapovic (2001) concludes that Croatian authorities formed their client groups: they included war veterans and invalids, war victims and their families, former political prisoners during socialism (some among whom were imprisoned after being accused of being ordinary criminals, so it was not always clear whether they were really victims of the undemocratic regime), former emigrants, especially those who declared that they left the country because of political and not economic reasons. The state budget financed their organizations (associations, societies) and in the process of privatization they received a preferred status. Legal possibilities for intervention in corporate matters were also used in order to give an advantage to people close to the leading party or to party members.

It is possible to think that the described pattern of the distribution of shares as a method of privatisation was reasonable and morally justifiable while others can claim that it was clientism. Later on it will be demonstrated that neither the political nor the social goal of the distribution of shares was possible to fulfil without an organised capital market – which didn’t exist.

\footnote{17 The document has been quoted already a number of times, and for a good reason. It was created by the leading Croatian economists, coordinated by Borislav Skegro, who later became vice-president of the Government responsible for the economy. Skegro (2007) declared that while being vice-president of the Government he followed The Conception and Strategy as an informal program of Croatian economic transition.}
4.3 Administration

A side goal of privatisation was to record and organise companies’ assets and to prepare basic data needed for the administration of business in new circumstances. Instead of a big revision Croatia got a big confusion. Administration of the first phase of privatisation was extremely chaotic. Companies themselves kept the books in which share ownership was recorded. There was no central register of shares.

In some companies individual shareholders formed associations to protect their interests, without much success. The distinction between individual shareholders and employees or between small shareholders’ associations and unions wasn’t very clear. As to what posed problems for them, sometimes they would be afraid of a threat from a majority owner, at other times their representatives would betray them. Individual shareholders were often not entitled to inspect the books so they didn’t know who the other owners of assets were (Privatisation, Nov. 1996: The interview with Mario Ivekovic and Adolf Culek, leaders of the Association of Small Shareholders). Often the owner(s) of a majority of shares manipulated them: workers were forced to sell their shares cheaply in a non-transparent market, in exchange for the promise that they would retain their jobs (Privatisation, Nov. 1996). When they were employees, the individual shareholders were often treated as “the remnants of socialism”; if they asked for their rights they were told – there was no self-management any more. Particular companies included in their statutes restrictions upon the transfer of shares: in some cases the only market was an internal market inside the company; sometimes, prior to being offered on an open market, shares had to be offered to fellow shareholders and the price was burdened by this restriction; sometimes shares might only be sold with the permission of the Supervisory Board of the company.\(^{18}\)

Companies’ assets in hundreds of cases weren’t accurately registered. Therefore, one of the implicit goals of the process, to put the administration of ownership in formal order, was betrayed – it could even be argued that in some cases the former socialistic system of administration was more successful than the new one.\(^{19}\) Very

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\(^{18}\) After the formal transformation of ownership rights the Government sold 49 percent of shares in the Nikola Tesla electric company to the Swedish corporation Ericsson, which together with some institutional investors held more than 51 percent of the shares. Majority shareholders restricted trade with the shares so minority shareholders were only able to cash out their shares ten years later. In other countries the verification of trade by a Supervisory Board are sometimes aimed to make a barrier to a hostile take over (Matijevic 2003).

\(^{19}\) In the case of Zagrepanka Meat Industry, the court accepted the register of assets from socialism as trustworthy and rejected the new one, compiled after the beginning of transition and privatisation (Pandzic 2006). It was not the only case.
often registers of shares were disputable, and opposing sides finished up in long lawsuits, trying to confirm their ownership and their rights. In a number of cases, claimants for the ownership of companies were members of the Croatian mafia who falsified documents about ownership or acquired them on the black market.\textsuperscript{20}

5. A brief comment on the first phase of privatisation

Self-management was a peculiar ownership structure in which the bundle of property rights was split between workers’ collectives and public bodies that usually represented local communities; the Communist Party, its interests and ideology strongly influenced the decisions of these public bodies. It appeared that self-management was not adequate for the organization of the business activities of a developed economy that was to be exposed to international competition. From the end of the 1960s the management class fought for changes of the property regime.\textsuperscript{21} Since the functioning of the financial system was heavily distorted, the individualisation of the rights to residual income and their transferability were proposed. Throughout this work I will follow the destiny of the management class during the transition from socialism and the development of the financial system.

The first phase of privatisation in Croatia (and in Slovenia) was an initial allocation of shares (property rights to residual income). Dispersed shareholding is a form of collective ownership but of a different kind to workers’ cooperative. Shareholders’ voting rights are differently distributed from employees’ voting rights; in the case of shareholding the right to a residual income is transferable, while in the case of workers’ cooperatives this transferability is usually restricted.

5.1 Costs and attributes

After the initial distribution, shareholders in Croatia encountered the problem of how to utilise their legal rights. The costs of organization of business activities under the new circumstances emerged. I have identified several

\textsuperscript{20} In the case of Zagrebacka banka a court case concerning an initial investment of 100 euros, which was rejected by the Bank as not valid, after a 15 year long trial was concluded with the judgement that the Bank must pay around 20 million euros (Rajić 2004 – “A boy from Knežija inherited 60 millions”; ‘A boy from Knezija’ implies the member of mafia). In another case, the president of the second biggest bank was beaten with a baseball bat, presumably because he didn’t accept that the Bank should pay 10 million of euros in respect of allegedly falsified ownership (Jelinić 2002)

\textsuperscript{21} Croatian sociologist Josip Zupanov (1983) developed the idea that the alliance between the Communist Party and the working class was blocking the modernization of the society and the innovative ideas of those excluded from that alliance (the intellectuals, the management class).
groups that fought for resources: the old and the new management class; workers; clients of the ruling party (war veterans and invalids, war victims and their families, former political prisoners); the Diaspora and foreign investors. The competitors were oriented towards different attributes of the resources: the interest of workers was predominantly how to retain employment; clients of the ruling party were oriented to drawing money from assets; strategic investors (Diaspora and foreigners) were oriented to seizing control over a company, since the capital market was undeveloped and exit was difficult and expensive; the new and the old management fought to stabilize their executive positions and power. Though all these groups held shares, their starting positions were different. The old managers enjoyed an informational advantage and established relations with business partners and creditors; however they were blamed for belonging to the old system. This latter characteristic they shared with employees as far as the exercising of property rights was concerned. The new managers enjoyed the support of the new ruling party and they were usually ready to undertake radical restructuring, as were the strategic investors.

5.2 The struggle and alliances

The traditional understanding that basically distinguishes public and private ownership without taking into account inherited business relations and routines, nor the influence of ideology and public opinion, i.e. social institutions that create incentives and constraints on the use of property rights, cannot adequately capture what then took place.\(^{22}\)

In a number of companies, workers and management established alliances; in the beginning it appeared to be a winning combination. Often it was the old management which won the support of workers\(^{23}\). However, smart new owners and new executives appointed by the new ruling elite were in some cases successful in

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\(^{22}\) The taking into account of tradition, customs, ideology, theoretical expectations and other social institutions one may consider a trivial truism that doesn’t affect the traditional approach to property significantly. This understanding assumes that social institutions only slightly disturb the workings of a private property economy. I do not think that this is correct. The idea that we have to pay attention to market institutions confirms a fundamental insight that ownership is costly; that economic property rights, which assume capturing of income flow, should be distinguished from legal property rights. Chapter II and III analyse theoretical distinctions between the two approaches.

\(^{23}\) Food producing companies *Frank* and *Vindija*, tourist companies in Istria, and machine producing company *Koncar* are examples
making an alliance with the employees.\textsuperscript{24} Much more often the conflicting groups struggled for control over resources that eventually led to their dissipation (see the interpretation of Luek’s analysis of initial appropriation in chapter II, section 4.4). The intervention of the government was frequently welcomed as putting an end to the destructive fight between conflicting sides. The arbitrary activities of the government were eased due to the absence of democratic tradition.

### 5.3 Decrease of the value of resource

The strategies of enforcement of property rights that were used by the old and the new management may be better understood following the insights and analyses provided by Douglas W. Allen (2002). According to Allen, an owner sometimes decreases the value of a resource under his control for the purpose of deterring a possible competitor. The decrease of the value of a resource increases the relative costs of taking over the resource assuming that the costs of the taking over are constant. Various tactics were used: as mentioned above, the executives sometimes intentionally decreased the assessment of the value of a company; tunneling (asset stripping) was described in chapter V; resources were overused. Low transparency of business was also a tactic to avoid predators. The executives (mostly the old ones) formed alliances with friendly bankers and converted a banking loan into equity, although it wasn’t necessary; it decreased the percentage of the equity available for takeovers and secured support from the banker. These phenomena confirm how costly property rights are, both their protection and their exercise.\textsuperscript{25} These phenomena confirm Allen’s insight that the relationship between the value of resource and the delineation of property rights is not necessarily linear; a better enforcement of property rights doesn’t imply an increase of the value of a resource.

### 5.4 The purpose of the administrative chaos

I would like to comment briefly on two features that were described above: the administrative chaos and the relationship between the authoritarian government and property rights. Administrative chaos has been a common feature of several countries in transition and the subject of several pieces of

\textsuperscript{24} Food processing companies \textit{Ledo}, \textit{Zvijezda} and \textit{Dukat} were taken over by the allies of the new ruling party but their employees were very satisfied with the new owners.

\textsuperscript{25} Allen (2002, p. 341) understands the costs of establishing and maintaining of property rights over an asset as “all costs of ownership, whether they are enforcement, measurement, moral hazard, or other such costs.” Allen emphasises that transaction costs cannot be reduced to the costs of exchange.
research. Allen’s (2002, p. 354) explanation that a hidden goal of American and Australian penal colonies was to discourage possible French and Dutch claims to the territory is here suggestive: “penal colonies lowered the value of the colony and made it less attractive to foreign aggressive powers”. By analogy, the administrative chaos in countries of transition increased the costs of the use of property rights and lowered the value of assets. For those people who quickly got control over the resource the chaos wasn’t a problem, but an opportunity. The uncertainty about when the rule of law would be established led them to choose an economic strategy of asset-stripping at the expense of other property owners (or the overuse of resources) instead of building the value of the resource; that gave them an interest the postponing the establishment of the rule of law. As a consequence, the assumption that a distribution of property rights would increase the demand for the rule of law appeared to be incorrect (for further arguments see Hoff & Stiglitz 2005).

As was expected, costly enforcement of property rights de-stimulates investment in fixed capital. In such circumstances, according to North (1990), small private companies remain small, while larger companies, although private, go under the protection of the state.26 As a consequence, costly enforcement of property rights influences the tendency for the size of company to decrease, except for those companies that are under the government’s umbrella. That pattern might be seen in Croatia. The distinction between private and governmental ownership blurs. The so-called agreement economy, which was the last phase of self-management (chapter IV) “was characterised by the tetragonal: company – local community – bank – Party Committee.” (PPEED 1001, p. 13)3 High costs of enforcement of property rights after the first phase of privatisation, re-established relations of almost the same character as had existed before: company – community (local, regional, national) headed by the ruling party – bank. It is concluded that under the transition, clientistic and predatory state re-emerged (Franicevic 2002).

Following Libecap (cf. my chapter III above), in circumstances of an unbridgeable disagreement about the distribution of assets, the problem might be resolved by a side-payment to one of the parties in the conflict. The transfer of assets to

26 “With insecure property rights, poorly enforced laws, barriers to entry, and monopolistic restrictions, the profit maximising firms will tend to have short time horizons and little fixed capital, and will tend to be small scale. The most profitable business may be in trade, redistributive activities, or the black market. Large firms with substantial fixed capital will exist only under the umbrella of government protection, with subsidies, tariff protection, and payoffs to the polity – a mixture hardly conducive to productive efficiency.” (North 1990, chapter 8)
preferred groups, workers, war veterans, former political prisoners etc., can be interpreted as side payments, though it stimulated the growth of a client’s state. As a consequence, the first phase of the process of privatisation in Croatia did not confirm the hypothesis that private property stimulates the development of a liberal democracy, which was a central postulate of the programs of transition in Croatia and a standard component of a number of scholarly papers that promoted privatisation (see for example Vojnic 1991, p. 89). Secondary privatization, which is the subject of the next chapter, describes the development of a market, particularly the development of a financial market in circumstances of the costly enforcement of property rights.

27 The Conception and Strategy (CSDERC 1992) consists of the same thesis.
Chapter VII

Privatisation and the financial market

In chapter VI the costs of enforcement and of the use of property rights after the first phase of privatisation were analysed. In this chapter I will focus on the relationship between property rights and the market. Investigation of how the characteristics of the market for securities shaped property rights, and vice versa – of how the costliness of property was reflected in the market of securities will be undertaken.

The authorities concluded that the initial allocation of rights didn’t produce many changes. The issue of the formal classification of ownership imposed a real problem for policy makers and analysts of the transition from socialism. The classification used by international institutions, which measured the progress of transition, wasn’t helpful; the distinction between public and private ownership was vague. For instance, the Croatian bank owned by the government of a state in Austria was categorised as private. An asset that was transferred to pension funds under the management of the government was considered public, though the income from that asset was to belong to individual pensioners. Though international institutions concluded that private companies generated 55 percent of GDP (TR 1997, p 14), many economists, employees and the general public considered the first phase of privatisation de facto nationalisation, even a step back in comparison to the previous system of decentralised governance of resources. I argued in chapter VI that the opportunity to manage business in formally privatised companies was more available to the government than to individual shareholders. Though the stipulations that enabled a direct involvement of the government in private business matters were soon cancelled (chapter VI, section 3 Authoritarianism), the indirect influence of politics was significant.

1 The initial allocation of shares to individuals, banks and governmental funds didn’t resolve the dilemma of what was private, what was public and what was collective ownership in regard either to the previous or to the new property regime. As for the previous system, from the fact that the proceeds from privatisation went into the state’s budget, follows that social ownership was considered public property (Uvalic, 1992, page 184). The significant discounts, which were given to the employees and citizens, might be viewed as recognition of their individual property rights under the system of social ownership.

2 The discussions in chapter II of what makes for ownership and what is the distinction between private and public property apply here.
The Prime Minister explained that the goal of the first phase was only to introduce “recognisable forms of market ownership” which would enable the Croatian system to become better harmonised with the legal and economic structures of Western countries and which would attract the activities of foreign investors to Croatia (Cuckovic 1998, p. 173). Jaksa Barbic, the author of the draft of the Law on the Transformation of Social Ownership, behaving in public as an authority and a reliable interpreter of the intentions of the Law, emphasised that the goal was only to create the “legal conditions” for privatisation (Cuckovic 1998, p. 178). Accordingly, real privatisation was still to happen, though shares were allocated to shareholders. If this was the case, what was to be a real privatisation?

After the initial allocation, shareholders in Croatia encountered the problem of how to utilise their legal rights. The owner of shares has the right to residual reward and – subject to particular preconditions – other property rights (e.g. the right to govern the use of a resource). Free riding on the efforts of other people is also an option: a particular owner of shares may conclude that it would be less costly (and more profitable) to him if he waits, while other shareholders take care of management and the control of the use of a resource. Finally, a share is a financial instrument, a form of saving. The owner of a share could use any of these options: he could use the right to receive a residual claim, ownership could be concentrated, or savings could be invested in dispersed shares. The nature of a market imposes constraints upon and shapes property rights. After people’s formal entitlement had been established, further development depended heavily on (1) the characteristics of the financial system and on (2) the preferences of shareholders, their habits, capabilities and their economic culture. Neither one of those two issues was taken into consideration by policy makers and analysts of privatisation in Croatia, since these problems – in my opinion - were placed beyond the theoretical framework and the concept of property that dominated the process of privatisation. Although particular authors have noted that the introduction of the basic institutions of the market for securities was delayed (Cuckovic 1998, p. 6; Sonje and Vujcic 2000; Sonje 2005) the relationship between the process of privatisation and the development of a financial market in Croatia has never been comprehensively analysed. Finally, two private stock exchanges were established at the beginning of 1990’s, but they did not have significant influence on the market for securities during the last decade of the 20th century. Neither of the Croatian economic institutes has ever conducted research into the process of privatisation and its outcomes. This might be explained as a consequence of the following:
Because of the notion that the backwardness of the financial market under socialism was a result of an inappropriate ownership regime, it was expected that the emergence of a capital market would spontaneously follow the initial allocation of shares. Intensive trade was predicted (CSEDRC 1992).

Under socialism the financial market was heavily restrained and ideologically deformed. In reaction to this Croatian economists advocated the minimisation of the role of the state and a shift of the responsibility for the development of the capital market to participants. They didn’t argue that there should be formal regulation to ensure transparency of the capital market and, as I have explained above (chapter V, section 4.2) they even insisted that the assets to be privatised were to be placed on the market without any evaluation of their value. I called this a market without information.

Whatever happened between participants on the financial market, every transfer of property rights was considered legitimate and – theoretically – the outcome that would derive from this was also expected to be what would be most efficient. Therefore Croatian economists deprived themselves of any examination and – thus – of criticism of the development of the capital market. The conditions for the evolution of the financial market and the problems of transaction costs and transparency were neglected.

Analysis of the relationship between privatisation and the financial market was also absent because of a lack of basic factual examination. The official statistics weren’t comprehensive; scattered newspaper reports weren’t reliable. Only in the year 2001 did the Croatian Parliament order the State Audit Office to conduct an investigation into the privatisation of more than 1500 companies. The report was published in 2004 and my analysis relies strongly on the findings of this official examination (SAORP 2004 – The State Audit Office’s Report on Privatisation).

The position of many was that companies weren’t privatised, although the fact that the shares were allocated was considered to be of importance. The dilemma distribution or selling in regard to the method of privatisation was still considered crucial for the transformation of the property regime. The attention of the public was focused on assets owned directly by the state, how they were privatised, and whether public tenders were intentionally designed to give advantage to investors that were close to the ruling party. Many scandals were discovered in this activity, but the main development – what was taking place in the market for securities – was somehow hidden and neglected.
The financial market in Croatia was traditionally banking-oriented. In the chapter on self-management I described its evolution from the period of central planning, to the late attempts at the introduction of financial instruments. In this chapter I shall describe:

(1) Croatian banking at the beginning of the transitional period (section 1). I mentioned earlier that banking was excluded from the first phase of the transformation of the ownership regime.

(2) The method of privatisation of banking (section 2). Banks were privatised “without privatisation”. Only 15 years after the beginning of the transition in the year 2005, at the request of the Parliament, did the Croatian National Bank did officially publish a report about the privatisation of banking (CNB Report 2005).

(3) The role of the banking industry in the privatisation of companies will also be analysed (section 3). Contrary to the prediction of Croatian economists, after the initial allocation of shares the capital market didn’t grow spontaneously. Its liquidity was close to zero. Shares in the hands of the 600,000 individual investors were virtually worthless. However, it wasn’t the same for all shareholders. The banks exchanged stocks among themselves and with some funds under the control of the Government. I will explain that it was an exchange of stocks without prices.

(4) A description of the banking crisis at the end of the 1990s follows (section 4). This crisis was a consequence of both the privatisation of banking and the role of banking in privatisation.

(5) A voucher privatisation (section 5), which was conducted in 1998, also belongs to the second phase of privatisation, when a lot of shares changed their owners. To support that process, a special type of financial institution was created: privatisation investment funds (PIF), which collected vouchers and exchanged them for shares. The comparison of PIFs’ activity and banks’ activity will hopefully clarify the nature of the financial market, its crashes and conflicts, which were decisive for the outcome of the second phase of privatisation in Croatia.

At the end of this chapter (section 8) I will analyse the process of secondary privatisation within the framework of the theory of property. This chapter might be understood as the most important for the hypothesis that the method of privatisation in Croatia, the concepts of (private) property and market that were
promoted by Croatian economists eventually led to concentration of ownership and that privatisation took the form of an initial appropriation.

1. The beginning of the financial market

The program of financial stabilisation, actually an anti-inflationary program from the end of 1993, and several waves of crisis and rehabilitation of the banking industry, were the two main characteristics of the development of the Croatian financial system during the 1990s. The purpose of this section is to identify the experience, the customs and the expectations, which market participants collected by navigating through these events.

The anti-inflationary program of 1993 was the most spectacular economic reform in the Croatian transition so far. The program successfully fulfilled its main purpose, i.e. the monthly inflation rate of 25-30 percent was taken under control. The program was in line with the measures recommended by the so-called Washington consensus. The exchange rate was used as an anchor for the goal of suppressing inflation. In 1994 prices even fell and from that time inflation has been low, and the exchange rate has remained at the same level with very limited fluctuations. The authorities declared that the free exchange of foreign currencies on an open market enabled inflation to be taken under control. Therefore my task is to identify the structure that was promoted as a free market.

Under hyperinflationary conditions in the beginning of the 1990s the Deutsche Mark ousted the domestic currency even as a measure of payment. The Government and banks as well as ordinary citizens used the Deutsche Mark for the quotation of the value of real estate, and of capital goods. It was mentioned earlier that bank accounts denominated in foreign currencies were allowed in Croatia. The domestic currency, which was the only official means of payment, was used only for daily transactions, due to hyperinflation. Prior to the anti-inflationary program the authorities usually determined the official exchange rate. Because it was unrealistic, a black market for foreign exchange flourished. Then it was

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3 I would like to remind the reader that the Washington consensus was an informal list of recommendations for countries in transition, as to how to reform their economies (Williamson 1994, 2004). It was obviously supported by the World Bank and the IMF. The list included privatisation, the liberalisation of trade and of foreign direct investment, deregulation, and fiscal stability and stability of the exchange rate.

4 The Croatian monetary system has remained “dollarised” until today. The term is from the area of influence of dollar. In Croatia it is today “eurisation”, and in the 1990s it was a period of dominance of the Deutsch Mark.
decided that the market should set the exchange rate. The government allowed citizens and companies to exchange their foreign currency holdings freely for the domestic currency.\(^5\)

Under inflationary conditions the domestic currency steadily weakened; banks and citizens were inclined to accumulate foreign currency. When the Government announced a program indicating the limit of the weakening of the domestic currency (the authorities were ready to intervene to support the value of domestic currency), banks were full of foreign currencies and short of domestic liquidity. The banks could collect domestic currency, which was necessary for daily transactions, by selling foreign currency to citizens, to other banks and companies or to the central bank. Some banks - having no money for daily transactions - were ready to decrease the price of foreign currencies steeply. The domestic currency had significantly strengthened. Since the majority of market participants were also short of domestic currency the final buyer of foreign currency was the Croatian National Bank which aimed to increase its foreign reserves; the CNB issued domestic currency only in exchange for foreign currency (this policy of “printing money” is usually called a currency board).

1.1 Organization of the foreign exchange market

Here it will be appropriate to explain a technical aspect of the foreign exchange market. Every morning the banks quoted their purchasing and selling rates for foreign currency for citizens; the banks made the morning telephone calls for trading currencies among themselves. However, most important was their quote for trading currencies with the central bank. They were sending their bids by fax: the price and the amount of foreign currency they were willing to sell. Nobody knew whether the best price was accepted. Banks weren’t able to see what the bids of their competitors were. The average exchange rate was published only the following day. It was calculated by using a method that aggregated all the transactions of the previous day - transactions between banks and citizens, banks and companies and between the banks. Hence, in the first period of the program that relied heavily on the market for foreign exchange, the largest amount of

\(^5\) I would like to add that only ‘new deposits’ nominated in foreign currency were freely exchangeable, but not ‘frozen deposits’ that were explained in chapter VI, note 13 and 14. However their relative value toward the domestic currency depended on the exchange rate at the moment of the unfreezing.
trade went through two fax machines in the Croatian National Bank. The effect was officially visible to market participants only on the following day. Because the CNB had the responsibility to make sure that the banking system was liquid and stable, it was granted discretion as to which price it took (not necessarily the lowest purchasing price). There was a possibility, because the market wasn’t transparent, that the central bank favoured some big banks by providing them with domestic currency (giving them money for state pensions and so on), regardless of their biding prices. There was also the possibility that some banks took too much risk, and acted irresponsibly by decreasing the exchange rate too steeply and that the Central Bank would reject their bids (not necessarily because of favouritism towards large banks). The market wasn’t transparent, and the non-transparency of the market made it possible for the central bank to abuse its monopsony position. I don’t know whether the Central Bank did so or not, but the possibility was evident. Rumours were widespread. Only later, when the market was fulfilled by the domestic currency and the exchange rate was stabilised, was the monopsony position of the Central Bank weakened. The amount of trade between banks, then between banks and companies and between banks and citizens eventually surpassed the amount of trade with the Central Bank. Protests by the banks that had the impression that they had been treated unfairly faded.

I would like to emphasise here the pattern that was promoted as a free market. The authorities argued that market participants must rely on themselves and decide for themselves; no official price of foreign currencies was established prior to trade taking place. That was understood as signifying progress from earlier socialist practice. Since the issue of transparency was neglected, the sense that the treatment of banks was unequal was widespread. The possibility that central authorities could intervene arbitrarily remained. This pattern only changed insignificantly during the 1990s. I will show below that the market for securities, where the second phase of privatisation was conducted, shared important characteristics with the foreign exchange market: low transparency, selective

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6 The above description of the anti-inflationary program (in sections 1. and 1.1) strongly relies on the book *The Road To Low Inflation* published in 1995 by the Government of Croatia and written by the creators of the program (Anusic et al 1995). It should be noted that at that time I was a financial journalist who followed the implementation of the program and the editor in chief of *Banka*, the leading financial monthly in Croatia. Some illustrative details that don’t substantially affect the meaning of the interpretation are result of my personal experience. For example, it was extensively discussed in the book (Anusic et al 1995) that at the beginning of the implementation of the program the largest amount of trade was between the banks and the CNB. But the detail that the CNB at that time received the bids through two fax machines is mine. In my opinion nothing would be substantially different if there were three fax machines, but there were two.
trading and the arbitrary behaviour of various institutions that monopolised particular market segments.

The anti-inflationary program was probably the most successful Croatian economic reform after the period of socialism. From 1993 the exchange rate of the Croatian currency, the kuna, toward the Deutsche Mark (and later the euro) remained almost fixed and the rate of inflation was under control. It is highly possible that the goal of the program couldn’t have been so successfully achieved without this arbitrary power of the central bank. There was a possibility that some (big) banks might suffer losses. Thus this might have led to illiquidity which could have unleashed an uncontrolled panic which would have undermined the program to control inflation. The point here is not to discuss the monetary aspects of the program but to emphasise the conception that a free market allocates resources efficiently regardless of the level of transparency and the equality of market participants.7

2. The building of the banking industry: three banking crises

This section serves to suggest a framework for understanding the relationship between the building of a capitalist banking industry in Croatia, the financial market and the ownership structure of the banks. Croatia entered the 1990s with 26 banks inherited from socialism. The rules for the establishment of banks were soon relaxed (Babic et al 1999, Jankov 1999). In the middle of the 1990s, the number of banks reached 60, i.e. more than thirty new private banks were established. But during the 1990s the banking industry passed through three waves of crisis. The first wave was immediately after the dissolution of the former Yugoslavia. Industry collapsed and “frozen deposits” backed by state bonds were introduced.8 Immediately after the end of the war in 1995, four of the five biggest banks that financed state owned companies during the war were rehabilitated: they got into problems from which they were rescued by the government. The third wave of banking crisis erupted in 1998. All

7 The market was described as “free and non transparent” (Franicevic, Sisek, 2001). I am not sure that this market deserves to be described as free. In my opinion this conception of a market, which neglects institutions, tacitly expects, if things go wrong, the intervention of a powerful market player (government or a big bank under the influence of the government) as a last resort. Only at the end of the 1990s, under the influence of recession, did some market participants take action that required a change in the understanding of an efficient market allocation. That will be described below, in the section entitled “The banking crisis and the evolution of the financial market”.

8 The “frozen deposits” were explained in chapter VI, note 13 and 14
analysts claim that the third crisis was directly linked to privatisation (see section 4).

Bad assets held by the banking industry at the end of socialism (1989) were “twice the size of the banks’ capital” (Jankov 1999). Insolvency was present in 13 out of a total of 28 banks.\(^9\) Separation of the Croatian banking sector from the former National Bank of Yugoslavia produced further losses.\(^10\) Therefore the Government of Croatia issued a series of state bonds to rehabilitate insolvent banks. Banks were heavily dependent on the capability of the state budget to fulfil its financial obligations.\(^11\) It is to be noted that the bonds that were issued to back up the banks weren't listed on the newly established stock exchange.\(^12\) It was mentioned in the section about the “management buy-out scandal” (chapter VI) that banks formed their own internal markets for securities and traded them with their clients non-transparently.

The rehabilitation of banking didn’t affect the ownership structure:

> [The rehabilitation of the banking industry] implied no penalties for banks and no changes in ownership, so there were no incentives for banks to change their behaviour. (Babic et al 1999)

The authors of the above quote were highly positioned officials of the CNB (Babic was a member of the board of the governor; Jurkovic was a governor, and Sonje was a chief economist); they explained why the property regime in banking wasn’t reformed:

\(^9\) “At the end of 1990... five banks were solvent, ten banks were solvent with problems in connection with the settlement of claims, eleven banks were technically insolvent and two banks were seriously technically insolvent.” (Jankov 1999, p. 3)

\(^10\) The National Bank of Yugoslavia controlled deposits in foreign currency, and commercial banks held claims upon NBY on the basis of those deposits. After the dissolution those claims, “which comprised approximately 50 percent of total bank assets”, became virtually worthless (Babic et al, 1999)

\(^11\) Fiscal expenditure for banking rehabilitation from 1991 to 1998 reached at least 31 percent of the estimated average annual GDP for that period. On the basis of an international comparison it was among the highest costs of bank rehabilitation in the last decades of the 20 Century: Kuwait and Chile spent more – 45 percent and 33 percent respectively, while Venezuela, Spain, Mexico, Hungary, Finland suffered significantly less burden, from 10 to 17 percent of the GDP collected from taxpayers and channelled into resolving the banks’ problems (Jankov, 1999). Rehabilitation claims on the government in 1993 represented 42.2 percent of the total assets of the banking system, “far above any comparable international standard” (Babic et al 1999)

\(^12\) Katarina Ott, a director of the Institute of Public Finance from Zagreb has written an article Banks will rule over Croatia (Banke ce vladati Hrvatskom; Banka, No 7, 1993). It was a comment on the method of bank rehabilitation (by using Government bonds).
The reason why the two rescue operations [from the beginning of the 1990s] had no microeconomic i.e. behavioural impact on banks, was that they were designed in order to prevent depositors’ panic and to maintain at least some level of public confidence during war-time.

This was the financial environment into which a new financial instrument, i.e. shares, was launched. The failure of to make structural changes in the banks that were rehabilitated was of significance when the third banking crisis erupted at the end of 1990s. A moral hazard of a very large character was identified. The new banks expected that political and monetary authorities would protect their depositors and cover their risky investments. The banking crisis wiped out of the market 14 out of a total of 60 banks, while two medium-sized banks were rehabilitated again. Additional costs weren’t negligible: to the loss of shares and the devaluation of deposits should be added the opportunity costs to the economy due to the dysfunction of the financial system. Analyses that were conducted mostly by professionals from the Croatian National Bank usually emphasised the problems of regulation and of the lack of capability of regulatory institutions to supervise development, that Croatia lacked an educated administration (for banking supervision) and bank managers trained in complex banking, though all of them found privatisation to have been an important factor in the chain of events (Jankov 1999; Babic et al 1999; Kraft et al 2002; Blejer and Skreb 2001; BS 1998). Hereafter, my focus will be on the relationship between privatisation and the financial system.

2.1 The privatisation of the banking industry

Even the economists of the analytical department of the CNB assessed the transformation of the ownership of the Croatian banking industry as extremely “intriguing” (Kraft et al 2002). The privatisation of banking remained obscured for years and was not something about which there was discussion. Only in the year 2005, when the discussion of privatisation had again acquired momentum, did Parliament request from the Croatian National Bank a report as to “how banks were privatised without privatisation”\footnote{It was often an objection of the critics of the process that the banks weren’t privatised following an official program.}, without anybody knowing how it had happened (CNB Report 2005). Banks were excluded from the Law on the Transformation of Social Ownership. In fact, the banks’ ownership was considered already transformed.
In Yugoslavia at the end of the 1980s, banks were obliged to register themselves as joint stock companies: the founders of banks, companies and communities, were registered as shareholders, receiving shares proportional to their initial investment. Croatia recognised this transformation of ownership. It was a variant of the proposal of “coexistence of private and social ownership” that was described in chapter V on the privatisation debate, except that employees weren’t recognised as owners. I have mentioned in chapter IV on self-management that in banking the influence of workers was minimal, since the management of banking requires professional skills. This explains why in the process of transformation of banking the ownership of employees wasn’t recognised. Nobody claimed that the banks were in a situation of no-ownership, though this was claimed for the companies that were formal owners of the banks. This may be explained by the fact that regulatory control, which is a natural characteristic of a developed banking industry – it would make no difference whether it was established by participants or by government, whether it was formalised or informal - may be more important for its functioning than formal ownership, which is restrained and shaped by regulatory control anyway. The former socialist banking sector was transformed by a purely administrative act into shareholding companies, and if their founders (i.e. the various companies involved) were formally privatised, then the bank became formally private, smoothly and without complications. However, the problem of “the coexistence proposal” was the possibility of pulling out collectively controlled assets into private hands (tunnelling, chapter V). Therefore, the further transformation of the banking sector and the industries that were tightly connected with banking should be analysed.

Here is how the biggest Croatian bank, Zagrebacka banka, described its privatisation:

In 1989 the Bank became the first bank in former Yugoslavia to be transformed into a joint stock company, registered at the Commercial Court of Zagreb. The first shareholders of the Bank were Croatian corporates. In 1990 and 1992 the Bank offered its new shares to Croatian individuals as well as corporates. With the privatisation process commencing in Croatia, corporate shareholders of the Bank were gradually privatised. In order to accelerate the privatisation of the Bank, in 1994 the Bank arranged regular public auctions of its shares to private companies and individuals. (ZB Listing 1998)

The good intentions of the bank’s management to privatise the institution autonomously should be accepted. Nevertheless, the process of privatisation of
the bank in its internal market, which was partly organised in a hotel in the capital city, Zagreb, was neither transparent nor regulated. The Bank held the register of shares and nobody knew whether shares were also sold outside this *ad hoc* market. Indeed, this was not forbidden. The problem of handling insider information wasn’t regulated at all. Even if it was not formally verified in any document or research, the Bank’s management certainly made significant use of its privileged position. Only when the Bank was listed on the London Stock Exchange a few years later, were holdings of the shares held by the Bank’s management to some degree disclosed.

From the annual reports\textsuperscript{14} of the biggest and the most successful Croatian bank, Zagrebacka banka, it is possible to confirm rumours and information which was not published at the time. The bank exchanged loans for its shares: from the beginning, the Zagrebacka banka accepted its shares as a guarantee for loans and when a loan wasn’t repaid, the Bank retained those shares within its treasury (AR 1998, pp. 81–83).\textsuperscript{15} The bank then exchanged loans for the shares of companies, which were sometimes shareholders of the Bank itself. Finally, the Bank had the opportunity to exchange its shares for the shares of companies. Cross-ownership was endemic. But that is not the only point.

The Bank had an informational advantage, knowing the performance of its clients and of the owners of securities, and was therefore in a position to trade selectively. The Bank had the power to provide a loan to one owner of its shares (a company) and to reject the request for a loan made by another company, which also might be ready to provide the bank’s shares as a guarantee. As a consequence, shares in the hands of one owner were worthless; while in the hands of another they were surprisingly valuable assets. This is how the attributes of the market shaped property rights, and such features characterised the Croatian financial market

\textsuperscript{14} The annual reports of Zagrebacka banka are available at the internet address www.zaba.hr; later in this chapter I will denote the annual report for particular year as - AR and add a year.

\textsuperscript{15} All subsequent annual reports have the same sections and subjects: *Equity securities, Owned shares held as collateral, Treasury shares*. In the annual reports we can see the flow of so-called treasury shares (shares of the bank, held in the treasury of the bank). It is interesting to consider the consequences of this operation. By authorising a loan to a particular company that cannot repay it and taking shares as a guarantee the Bank actually excludes a particular shareholder from its ownership structure. This may be a perfectly rational commercial operation: existing shareholders buy equity from other shareholders and increase their own investment. The fact is, that this equity market wasn’t transparent in Croatia at all; these transactions weren’t regularly published, even after the Bank was listed on the Zagreb Stock Exchange in 1995, only their final effect was recorded in the annual reports. Other market participants were deprived of information. This equity market was under the control of the Bank’s management.
until the end of the 1990s. Clients of one or another bank, as well as the owners of the bank’s shares, had narrowed opportunities to manage their assets, to calculate their benefits and costs, or to decide to take a risk or to leave the game. From the annual reports of banks, it is possible to trace how, around the particular banks, interest groups were formed that sometimes behaved toward other groups as a clan; how some companies were ousted from the group and how the influence of others was strengthened. It might be that the behaviour of such clans was perfectly rational, but without a transparent market one could not assess it. These groups around banks certainly represent a continuity of the structures that were formed during the last phase of self-management under the framework of the agreement economy: bank – community – party – company.

Zagrebacka banka was the first East European bank listed on a Western stock exchange in 1996, after its listing on the Zagreb Stock Exchange in 1995. Listing in Zagreb required at that time minimal transparency, and the stock exchange was basically illiquid. Therefore, being listed didn’t provide much security against exclusive contracting, discriminatory pricing and selective trading. According to the changes of percentage of the shares in the Bank’s treasury, reported in the annual reports, it is reasonable to suppose that the trading of shares had continued off the official market. It wasn’t restricted.

The listing on the London Stock Exchange, in a special quotation SEAQ International (Stock Exchange Automatic Quotation), didn’t increase the transparency of ownership. All shares traded abroad were transferred into special certificates of ownership (GDR – global depository receipts) and held by the Depositor, which was actually the Bankers Trust Company. The Depositor was the only seller and the only purchaser of shares (GDRs). If one wanted to trade shares this was conducted by informing the Depositor, and it took place according to the then current quotation. The Bank stated that it don’t know who the owners of its shares were (AR 1998, p. 40). It only became obvious subsequently, from the reports that the percentage of shares held by the Bankers Trust was increasing continuously. Basically, it was very similar to an internal market, like the one that was described above,

16 See the above note that explains the content of annual reports of Zagrebacka banka.

17 The agreement economy was described in chapter IV on self-management, section 4.3

18 “The Bank cannot determine the ultimate holders of the GDRs...” (AR 1998, p. 40)

19 The percentage of shares controlled by the Bankers Trust increased in the year 2000 to 62 percent from 42 percent in 1997 (AR 2001, p. 30).
but more liquid. The Croatian banking law stipulated (ZB Listing 1998, p. 6) that the written consent of the Croatian National Bank is required prior the acquisition of a particular percentage of shares. However, the Depositor of certificates listed in London was excluded from that obligation.\textsuperscript{20} Therefore, among shareholders might have been managers of the bank or managers of connected companies, without anybody knowing it. The problem of insider trading wasn’t seriously considered. All that is traceable was that the Depositor supported the management at every annual meeting. When the percentage of shares held by the Depositor increased to over 50 percent the Depositor didn’t have a duty to propose a take-over to all shareholders, even though at that time the legislation already required it, because the Depositor was only considered a trustee. Later on, the management, acting as an owner, arranged the take-over of Zagrebacka banka by the Italian bank UniCredit.

It should again be emphasised that Zagrebacka banka has been the most successful Croatian bank. Due to relatively high transparency of the business activity of that bank\textsuperscript{21} it is possible to assemble these pieces of information about the method of its privatisation, which was certainly more sophisticated and more transparent than the privatisation of many other Croatian banks and companies. The management of Zagrebacka banka also organised an ESOP (Employees Stock Ownership Program) for its employees, and therefore they were somehow compensated for their loyalty and eventually felt less impaired in comparison to those who had access to insider information. The other banks were much clumsier, but in essence a lot of smaller banks were privatised following the same method: a closed internal market, the exchange of shares between companies and banks, and the swapping of loans and shares.\textsuperscript{22} This privatisation simply describes the characteristics of the financial market in Croatia at that time and, consequently, it affected the real economic property rights of shareholders.

\textsuperscript{20} This is an interesting moment. Listing on a Western stock exchange was considered so advantageous and favourable that almost any concession was acceptable. Actually, the listing on the LSE enabled the management to be protected from the detrimental influence of Croatian politicians and also from the predatory intentions of Croatian tycoons who were openly eager to take over the Bank (Banka, financial monthly, October 1997: an interview with Miroslav Kutle).

\textsuperscript{21} Zagrebacka banka was the first Croatian bank which published annual reports, the first bank which was to be rated by three major international credit agencies, the first East European bank listed on the LSE.

\textsuperscript{22} Several larger banks that were strongly connected with public companies and state owned companies were again rehabilitated after the war and sold to foreign investors.
3. Banking and privatisation of companies

To get the entire picture about privatisation in Croatia the role of banking in the process should be further elucidated. Basically, the transformation of ownership in the banking industry, which I have just described, gave a decisive direction to the further privatisation of companies. Here, I would like to stress four points.

• Banking professionals were closely involved in the process of the appraisal of the value of companies to be privatised.
• The Law had opened the possibility of debt for equity swaps, actually for the transformation of loans into shares. Therefore banks acquired a significant amount of ownership and control over companies (which sometimes were the bank’s owners). In many cases it was the only way to save non-performing loans.
• Very often, banks prepared the complete process of privatisation. Non-transparent loans for management were already mentioned as a cause of protests, but banks also organised ESOP (Employee Stock Ownership Programs) in some companies.
• Finally, inside the banks were formed mini capital markets where companies, and the bank’s clients, exchanged stocks and debt. As was mentioned, the banking market in Croatia was traditionally segmented (Kraft et al 1999); Croatia had a number of closed security markets. Shareowners usually didn’t have many choices or possibilities to manage their assets.

In 1995 the Croatian Privatisation Fund revealed that banks dominated among the biggest shareholders in Croatia (Privatisation No 2, Feb., 1995). Given the fact that banks mostly invested in the tourism industry, the title of the report was: The biggest shareholders in Croatia: Banks love tourism. After the first phase of the transformation of ownership the biggest shareholder emerged as being the biggest bank at that time, Privredna banka Zagreb, which acquired ownership in various companies mostly by swapping loans for shares. The second position was held by the oil monopoly Ina, which had extensive ownership in the transport industry and in tourism. Banks occupied the third, forth, and fifth position; sixth was the first foreign investor and smaller banks were also in top positions. The biggest private (individual) entrepreneur Ivica Todoric, the owner of the conglomerate Agrokor, collected majority ownership in several companies mostly in the food processing industry and the retail industry and had won 7th position. But something should be clarified: Zagrebacka banka provided loans for Agrokor’s acquisitions of other
companies and this heavy financing later caused problems for the Bank due to its high and risky exposure. Almost all banks had one or more “house tycoons”.

The Croatian Privatisation Fund published a report (Privatisation No 2, Feb., 1995) detailing in which companies the banks held significant ownership. From this report and the earlier mentioned reports of the State Audit Office it is possible to reconstruct further developments. The exchange of shares that followed, which will be explained below, was of a character that reminds one of “the markets without information” model that was described in chapter V, on the privatisation debate. It is to be noted here that in chapter V was discussed the thesis that the assets to be privatised *must* be placed on the market without prior evaluation so the market participants would be the first who would evaluate them and price them. This view was understandable bearing in mind the experience with the governmental regulation of prices under socialism. However, this proposal didn’t see that the market will be absent without information and that it might lead to an inefficient allocation of resources. In the following section I do not propose the governmental evaluation of assets to be privatised; I only describe what was consequence of the missing evaluation. In the next chapters I will show how that problem was encountered in Slovenia.

3.1 Markets without prices

The bulk of shares had been exchanged in a non-market manner between the banks, then between the banks and companies and between the funds controlled by the state (pension funds and the Croatian Privatisation Fund) and banks and companies. What does “non-market manner” mean here? In a number of cases the Audit Office identified that “the contract didn’t specify the purchasing price or the goal of the transfer [of shares]”\(^{23}\). The State Audit Office conducted a detailed examination of “selling and exchange of shares in ownership of the State Pension Insurance”. The report stated “in some exchanges the shares that were accepted or the shares that were given hadn’t been evaluated [meaning that they hadn’t even been priced] ... neither was the goal of the exchange defined” (SAOR Pension Fund 2003)\(^{24}\). Hence, the price didn’t matter. It was bulk trade, actually a barter of stocks. The same thing applied to the exchange of stocks according to so-called

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\(^{23}\) This quote is from the report on the transformation of ownership and the privatisation of the retail company Nama (SAOR Nama 2004, my translation)

\(^{24}\) However, what I reported on in the text was assessed as a minor infringement of the rules (author’s translation)
nominal prices, which were administratively estimated in the preparation period for the transformation of ownership. Again, the price didn't matter.

As was obvious from the reports, the outcome of a massive exchange without a transparent market was the concentration of ownership and the ousting of the individual shareholders without compensation. Take-over legislation was enacted at the end of 1997, but it imposed duties only on private investors. State-owned funds were excluded from the duties stipulated for the take-over procedure (a report on the concentration of shares, an offer of a fair price to all shareholders), therefore some possibilities for exploiting minority shareholders continued. I mentioned earlier²⁵ that two thirds of such shareholders gave up and abandoned their assets. The Audit Office also found in a number of cases that the state-owned funds didn’t respect the requirement to publish the tender for a particular swap, although they were obliged to do this, and no trial or punishment followed.

It must be taken into account that the first phase, when shares were allocated, was considered only a “precondition for privatisation”. One can say that this was the real privatisation of nobody’s ownership, which – consequently – took place without prices. As for “the goal of exchange”, the state-owned funds had in their statutes, verified by the Government, the stipulation that they exchange shares with the purpose of concentrating ownership²⁶. The motivation as to why concentration of ownership was indicated as a goal was the “better management of assets” (in the Pension fund), and indeed it was possible that the management of assets was easier if ownership was concentrated in the circumstance of an illiquid market for securities. It was believed that concentration of ownership eases the search for a strategic partner.

I would like to remind the reader again of the problem of a “market without information” that was elaborated upon in chapter V about the privatization debate. Croatian economists strongly argued against the evaluation of assets to be privatized. They expected that “intensive trading” would take place and that the outcome of it and of the determination of market-based prices would be responsible owners and active investors. The idea was, that the market exchange of shares

²⁵ Footnote 10 in chapter VI.

²⁶ Several official directions of the Ministry of Privatisation from the year 1996 (available on the Internet site of the Official Gazete www.nn.hr) indicated the necessity for the concentration of ownership (for example DMP 21/96); this was also recorded in the reports of the State Audit Office (for example SAOR Pension 2003).
would show that any prior evaluation was incorrect, or at least not necessary and, perhaps an impediment to the workings of the market. I think that their prediction was fulfilled, unfortunately. The hidden exchange of shares was possibly intensive. The administratively evaluated price of assets really didn’t matter; the shares were exchanged at nominal prices or without prices. Only the number of the exchanged shares mattered.\textsuperscript{27} This was a consequence of the fact that neither the evaluation nor a price as such mattered, and the intensive exchange of shares, in my understanding, wasn’t a market. The description of the destiny of individual shareholders that follows will confirm that a market without prices should really be seen as amounting to a pure grabbing or the first occupation of nobody’s property – despite, in this case, there were people who owned share certificates.

3.2 The destiny of individual shareholders

The Final Report of the Audit Office shows that after the first phase, in 36 percent of companies’ workers and former workers had a majority ownership, while after the exchange and concentration of ownership that proportion decreased to 12 percent (SAORP Final 2004). This took place without compensation, it is important to emphasise. In two thirds of companies (68 percent) individual shareholders retained less than 50 percent of the shares. But without a liquid market their status was unimportant for companies: they were ignored in company matters; no dividends were paid, etc. In reaction to this almost two thirds of individual shareholders stopped paying their instalments and were erased from the books. Their shares were returned to the Croatian Privatisation Fund.\textsuperscript{28} The figure that individual shareholders retained shares and minority status in 68 percent of companies has several explanations:

**Patience** - some people were patient;

**Inertia** - after the initial subscription people simply didn’t bother any more about their shares and retained them because in some companies payment was organised by means of an automatic subtracting of instalments from their wages;

\textsuperscript{27} The State Audit Office reports about the attempt of a big swap of shares between several banks, the Government and the tourist companies. Zagrebacka banka, which was avant-garde in the promotion of market behaviour, requested an assessment of the value of shares by the international audit agency. That swap was cancelled two years later. It seems that other participants, the Government among them, only favoured the exchange at the nominal price. (www.revizija.hr)

\textsuperscript{28} Due to imprecise legislation and careless administration, it often wasn’t clear who actually owned the shares, and sometimes the Privatisation Fund was selling what was in court claimed to be shares owned by other people.
Employment – The Audit Office reports that workers complained about “being fired, despite the fact that they regularly paid for their shares” (SAORP Final 2004 my translation), so they believed that by subscribing to shares they purchased their employment. Obviously, a lot of people didn’t know what they had in their hands, what they could do with it, whether it was worth saving or not.

Finally, years later, some people were lucky to be able to cash out their shares for a decent price, when a particular strategic investor took over their company. But this was very unusual. Much more often individual shareholders were forced to sell their shares on an obscure market under threat that they would otherwise lose their employment, or were ousted from the company after a bankruptcy that was pushed for by interest groups, which aimed to grab companies’ assets (e.g. real estate). 29

It is reasonable to suppose that the behaviour of the banks was basically rational. Or at least that it wasn’t completely irrational. They gathered control over companies and in many cases transferred it to strategic investors, foreign or domestic, in some cases to the existing management or to a group of related companies. Whether an economic case might be made for the benefits of concentration of ownership and the exclusion of individual shareholders is not an issue here: the fact is that they predominantly weren’t compensated as were the other, privileged shareholders, because the exchange of stocks among big players wasn’t governed by market prices available to all. Individual shareholders in Croatia usually didn’t have a chance to cash out their holdings on the basis of transparent market prices. Their shares didn’t pay dividends, and they couldn’t sell them on the same market on which banks and state funds exchanged property rights.

It should be emphasised that Croatian economists predicted that individual shareholders might sell their holdings cheaply, but they considered this to be the responsibility of individual shareholders only (Buvac 1990, p. 17). The Conception and Strategy that was created in 1992 by the leading Croatian economists under the coordination of later vice-Prime Minister Skegro explicitly stated, “why would anybody care about it” (CSEDRC 1992, p. 27). This clearly confirms that the above-described process was within the theoretical framework of Croatian economists. At best, the assets distributed to individuals were, anyway, understood as being part of

29 The State Audit Office informs us that 22 percent of the reviewed companies were bankrupted. These weren’t start-ups, but companies which had been on the market for long time (SAORP Final 2004)
“welfare policy”. Consequently, it was not assumed that individuals would use their shares for any other purpose than for consumption; they would not participate in management. This attitude eventually decreased the value of shares.

Individual shareholders in Croatia tried to do what they could: they formed associations of minority shareholders and acted, together with the unions and opposition parties. Sometimes nobody knew whether a particular negotiator represented workers or individual shareholders or a political pressure group (Privatisation Nov. 1996). Usually they didn’t achieve much success. Sometimes they even didn’t have access to the register of shareholders. Their actions were often condemned as the activity of people trying to assert political pressure. Though they were shareholders they were denounced as “remnants of self-management”.

Since big players ignored the associations of individual shareholders, it might be expected that free entry and the development of a market would provide a chance for those who thought that their treatment wasn’t fair. If big players (old banks, tycoons, predators, or state funds) didn’t offer a fair price to individual shareholders it seems reasonable to assume that somebody would see an opportunity to open a new bank and to approach minority shareholders. It was sensible to suppose that after banks started to consolidate control over companies, and when this strategy showed initial success, new players, and new banks would emerge on the same market. And this indeed happened.

4. The banking crisis and privatisation

The number of banks in Croatia (4.5 million population) increased from 26 in 1990 to 60 in the second half of the 1990s (Jemric & Vujcic 2002, p.2). At the end of the decade Croatia suffered a new banking crisis. As was mentioned, one fourth of the banks were wiped out of the market, and the Government rehabilitated two middle-sized banks, which were “too big to fail”. This new banking crisis occurred in the circumstances of private ownership and a market economy (not yet developed), hence it should have been different from the previous crisis when the irresponsible financing of companies was attributed to ideological requirements and to an inadequate ownership structure. The banking crisis provides a good occasion for an analysis of what had substantially changed after the fall of socialism, what kind of economic structure had really developed and of what kind of social and political system had emerged.
After the first phase of privatisation, when the ownership of shares was extended to individual shareholders (mainly as a form of social policy), then to banks and state owned funds, and after an expensive general rehabilitation of the banking system, it became clear that a large part of economic power had been transferred to the banks. The growing power of the banking sector attracted the emergence of new banks. While seven newly-established banks in foreign ownership were mainly cautious and conducted their affairs only on the basis of standard banking practice, accepting deposits and giving loans, some new domestic banks imitated the practice of the old banks and joined in the rush for control over companies:

Since some of the big old banks didn’t have the resources to grow because of the burden of the past, the newly emerging private sector took the opportunity to gain a larger market share. Some of the rapidly growing new private banks engaged in connected lending (often in relation to the privatisation process) and lost control over the assets’ quality. As one might expect, market failure occurred. (Babic et al 1999)

“Connected lending” denotes here an incestuous relationship between a bank and its owners: banks were forced to lend the money of depositors to the owners of the banks, rather than to the, possibly more profitable, bank’s customers. Many countries in transition passed through similar difficulties. The economic aspect of the crisis is clear and has been elaborated upon in a number of analyses. In the report The Banking System in 1998, which was published by the Croatian National Bank, it is stated:

A frequent occurrence in Croatian banks are debt-equity swaps. In this way banks come into possession of unwanted equity portfolios, very often as sole or majority owners. Such investments are difficult to evaluate because of their undefined market value. As equity capital, they are also difficult to sell on the undeveloped capital market. The acquired portfolio only burdens banks’ balance sheets without bringing any profit. (BS 1998, my emphasis.)

In my opinion the assessment that such a portfolio was unwanted usually wasn’t correct. There weren’t any reasons for the newly established banks to come into possession of an unwanted equity portfolio. Many of them didn’t do it, particularly foreign banks. However many new banks saw opportunity in the imitation of the practice of the old banks, which developed their internal financial markets
in association with affiliated companies and organisations. The new banks struggled to provide as many loans to companies as possible trying to eventually get into possession of shares. Because they were largely acting in the dark, it is not surprising that, in many cases, they ended up with assets which were worthless. The already quoted authors from the Croatian National Bank wrote:

[The impact of politicians on banks] is one of the greatest dangers for sound banking and in some countries, especially countries in transition, it can have a systemic character. Although the state-owned banks are likely to be the first under pressure, *private ownership is not a sufficient condition for the elimination of this jeopardy, especially if a bank is regionally oriented* ... Connected lending, exposure to a connected group of enterprises, and a lack of portfolio diversification ... all add to the likelihood of a crisis. (Babic et al 1999, my emphasis)

The banking crisis exploded in the first half of 1998, after a short fight between members of the Supervisory Board and the CEO of Dubrovacka banka, at that time the fifth largest bank in Croatia and the dominant bank in the developed tourist region of Dubrovnik. The bank was investing extensively in the equity of tourist companies and fell into a crisis of liquidity. Therefore the Bank stopped financing the acquisitions and business of the biggest Croatian tycoon, who was also a very well positioned member of the ruling party. The Supervisory Board then fired the CEO, and there was a run on the Bank; the Croatian National Bank was forced to provide a large amount of credit to maintain the bank’s liquidity, and later the Government took over the ownership of the bank and rehabilitated it because of its regional importance. Fourteen other banks with similar solvency problems weren’t rescued (Faulend and Sosic 1999, Cuckovic 2002, Sonje et al 2001).

### 4.1 The political aspect of banking crisis

The banking crisis impacted on the evolution of the financial market, which is my central interest here. However, to get the full picture it is important to describe the political (ideological) aspect of the crisis first. The public was divided again between two groups that frequently accused each other of “communist practice”. It was similar to the division between the old management and the new management.

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30 A number of studies conducted by the Croatian National Bank focused directly or indirectly upon the banking crisis are available at www.hnb.hr. Also, the above quoted papers quote a number of newspaper and magazine articles related to the subject.
of companies, which was described earlier (chapter VI, section 4.1), and partly the same people were involved in the ideological battle in regard to the banking crisis. The managers from the era of socialism who survived the first years of transition were accused of continuing their old behaviour, which was characterised by their obeying political orders. The newly emerging business elite was blamed for the repetition and imitation of old practices; something that was claimed to be evident in the strong relationship between them and their political patrons.

The banking crisis unveils the characteristics of the political system in Croatia at that time. Two economists from the CNB later wrote:

[T]he Croatian National Bank 'knew' what was happening for almost a year before the fifth largest bank failed, which raised frustration even higher. People outside the bank thought that knowing about early signals was enough to be able to act. It was concluded that the central bank was too politically weak to act. This implies direct political responsibility and the erosion of credibility. (Sonje & Vujcic 1999, p. 14)

Hence, the CNB was legally responsible but it didn't have enough political power to act. The Croatian National Bank in June 1997 submitted a report to Parliament entitled *Banks at the Crossroads* (BC 1997), emphasising the risky growth of a group of middle-sized banks\(^\text{31}\). Producing such a report was not within the formal duties of the CNB; by submitting it the Central Bank was seeking political support. But in fact, nobody cared, except for a few business journals. The parliamentarians knew that politics was not actually in their hands but in the hands of the President’s Office, where everything was solvable by lobbying. The CNB didn't have a chance to manage the risk in the banking sector transparently and systematically. The banks with a better position in the President’s Office asked for special treatment and some of them even got it. (Cuckovic 2002, Sonje and Vujcic 1999) The CNB at least withstood the pressure to abandon the goal of keeping inflation low (which was its duty by law) and didn’t print money. It was the first time after socialism that the CNB stood firm. In political and business circles nobody believed it could have happened that the CNB withstood the pressure to print money. Whether this firm behaviour of the CNB could be considered a signal of the progress of democracy and of economic transition is a matter for discussion. Political lobbyists were angry and eager to secure privileges for their clients among the

\(^{31}\) The average asset growth of these banks was 81 percent in 1996. (*Banka*, financial monthly, Oct. 1997)
banks and companies affected by the banking crisis, but the CNB somehow won support from the public, though the Governor at that time, Marko Skreb, was under a propaganda attack from the newspapers connected to particular banks (see a weekly Nacional 1999). It seems that the Croatian people half-consciously remembered the problems with high inflation and in consequence were willing to accept the bankruptcies of particular private banks, which were known to the public for their predatory behaviour, together with their big depositors and connected companies. (The Government had earlier increased the limit of insurance of personal deposits; hence the average person was protected.) The CNB didn’t give up even when Croatia went into a short recession in 1999.32

4.2 The banking crisis and the evolution of the market

In the middle of the financial crisis in 1999, the decision of thirteen larger banks to establish a private banking association, having the purpose of organising a transparent financial market, represented a significant step in the evolution of the Croatian financial system. The members of the association agreed to reject financial trading with other legally registered Croatian banks (i.e. those who were not members), declaring that lending to them would be too risky. Until this decision, trading on the official money market was organised so that every day, all registered banks quoted their ask and bid prices (rates) for overnight loans and other short-term transactions (three days, one week, one month). Discriminatory contracting was not supposed to happen: every registered bank had access to every other, if it was attracted by the prices that they offered. Since the banks with liquidity problems borrowed money extensively, this pushed up the overall interest rates such that they exceeded 30 percent. As the problem of liquidity intensified, some banks failed to fulfil their duty (to return short-term credits). They were counting on terribly slow judicial procedures, while waiting at the same time for government support. The law stipulated that the Government had a right to estimate, following particular criteria, which bank should survive and be rehabilitated and which should be left to bankruptcy. The authorities were under pressure from the lobbies that were formed around some banks, usually concentrated in certain Croatian regions, or which specialised in business with particular industries (agriculture, tourism), to give support to banks regardless of their underlying strength. The Central Bank was under pressure to relax its policy

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32 This recession occurred not only as a consequence of the banking crisis but also as a reflection of the financial crisis in Asia and Russia and because of NATO intervention in neighbouring Kosovo, which damaged Croatian tourism that year.
of sound money, by allowing the commercial banks to use their obligatory reserves in order to finance their daily transactions. Lobbyists in fact demanded the printing of money as a solution for their difficulties. The Central Bank withstood pressure, but it was also reluctant to exclude illiquid and insolvent banks from the market, waiting for the decision of the Government.

In these circumstances thirteen healthier banks, among them the biggest four, decided to establish the Croatian Banking Association and to form a closed financial market. It was a clear example of spontaneous, private regulation of the market. The criteria for membership were much stronger than the norms that were stipulated in the banking law for entering the official financial market. Most important for this research, was that the Association required “fair business competition” and higher transparency from businesses. Later on, the new banking legislation strengthened the technical norms for the banking business, obviously following criteria affirmed by the Association, and concluding that the banking crisis was the outcome of weak regulation and a weak regulator. Various interpretations of these occurrences are possible; for example the proponents of spontaneous order could emphasise that the market participants created their own norms of behaviour which were later accepted by an official regulatory body. I will now analyse this process within the framework of property rights theory and in the context of the political and social limits of property rights.

4.2.1 The same rights, different costs

At first glance, banking practice in both groups of banks looked very similar. The old and the new banks practiced debt equity swaps, cross shareholding (companies in the equity of which they invested also owned bank’s shares) and high investment in non-liquid assets. And indeed, the legal property rights were the same for both groups, but the costs of enforcement of rights and the costs of the use of resources were different. As already mentioned Lueck’s (1995) paper distinguishes the costs of first possession in the case of single claimant and in

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33 Obligatory reserves are a common instrument in the banking industry, which the regulator uses to increase the security of banking and to strengthen confidence in the financial system. I would like to recall here the description of money management under socialism in chapter IV, when different accounts, i.e. different functions of money, were strongly separated. Because the regulatory body, at the beginning of socialism, wanted to control all transactions, not just the overall performance of a particular, therefore it requested separate accounts for wages, business transactions and investment. Later, the purpose of regulation became the security of the system; therefore the regulation was relaxed.

34 It was required that the member-bank was to be certified by a recognised auditor.
the case of a race for resources (chapter III). However, in the former case a single claimant might calculate and establish his rights at the moment when his costs are the lowest. Since the old banks had already established relationships with the companies of which they owned shares, they were less exposed to a competition for resources. The new banks tried to achieve control over resources as early as possible; therefore their costs of appropriation were high. Debt equity swaps, cross shareholding and high investment in non-liquid assets in the old banks were - to a degree - seen to be a consequence of a socialist legacy; this was presented as their destiny and debt equity swaps as a kind of sacrifice made by old banks. Political lobbying and enforcement of their rights were cheaper. When the new banks started to imitate the pattern of the old banks, public support for this kind of practice had already faded, because of the marginalisation of individual shareholders and employees. All of that increased the costs of property rights for the new banks.

4.2.2 Property rights and values

The battle between the old and the new banks showed that regulation includes the promotion of values. The old banks advocated the security of business practice, while the new banks promoted aggressive competition. It was obviously possible that their lobby groups - by advertising contrasting values like stability or competitiveness - in fact promoted market regulation that was favourable to their clients. The old banks advocated responsibility in financial management only after several expensive rehabilitations of the banking industry and after they had structured their portfolio on a non-transparent capital market (which was described above). At the same time, it was obvious that the banking crisis from the end of the 1990s forced the evolution of the property regime towards increased stability in the financial market. At the beginning of the transition, the leading idea was different: the goal was to relax the criteria for opening a bank in order to increase competitiveness. This was the argument of the new banks.

At the beginning of the 1990s the Government saved the financial industry, leaving the ownership structure untouched. In the middle of the decade, four of

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35 Actually, Lueck distinguishes several types of race: homogenous claimants with incomplete information; heterogeneous claimants with incomplete information; heterogeneous claimants with common knowledge and calculates the costs of enforcement of property rights and of the use of a resource. Similarly, Lueck distinguishes the situation in which a single claimant is first-best and the situation in which a single claimant bears positive costs of exclusion. (Lueck, 1995)
the five biggest banks were rehabilitated, but their management was replaced. Foreign investors later acquired these banks. However, the new banks required similar support to that which the government had provided for the old banks throughout the 1990s. At the end of the 1990s, some (private) banks were left to become bankrupt. Although this partly undermined confidence in the system, this was presented as an affirmation of the principle that the market punishes inefficiency. Sometimes, it is impossible to distinguish whether changes in the property regime benefit the entire society or if they fit only the narrow interests of a particular group. (This is argued in chapter III, in the section that discusses the evolution of property regimes).

I would like to clarify here that my wish is not to advocate the formal governmental regulation of the financial industry, or of any other industry, as a solution for an inefficient allocation of resources. Regulation could be left to market participants as well. It was explained in chapter III that legal property rights in essence only enforce economic property rights (or prevent their evolution). Legal property rights can decrease the costliness of property but also increase it. Regulation in a wider sense includes all market institutions, from customs and informal norms to laws. My concern here was to look at how these norms evolved and how they affected the efficiency of the allocation of resources.

4.3 Voucher-privatisation

This type of privatisation was long demanded, actually from the beginning of the 1990s, by the proponents of so-called shock economic reforms. It was promoted as a form of market privatisation, meaning that the state would have minimal influence on the outcome. The advocates of voucher privatisation in Croatia didn’t articulate their idea in detail. Rather, they accused critics of voucher privatisation of upholding state ownership and state interventionism. While the criticism itself was sensible enough, that didn’t of course mean that what was being proposed by those who favoured voucher-privatisation itself made sense. The most famous example of voucher privatisation in the countries of transition was conducted in the Czech Republic and, initially, it was celebrated as very successful, because shares were transferred from state ownership. Later, it was also criticised, because shares ended up in the hands of funds controlled by the Government.

In Croatia, vouchers were finally distributed to 240,000 victims of the war (members of the families of those who suffered casualties, war veterans, invalids
etc). The idea obviously wasn’t primarily that they would be active participants in the financial market. Rather, it was expected that they would use their vouchers for solving their financial problems. In some other countries, for example in Slovenia, vouchers were distributed to all citizens. The voucher owners had the opportunity to exchange their vouchers for shares in a particular company, participating personally in an auction of shares, or to invest them in specially designed institutions, the Privatisation Investment Funds (PIFs). According to the State Audit Office, only a few more than 10,000 people individually participated in the auctions, mostly competing for shares in companies from their city, or for companies in which they were employed.

In essence voucher privatisation repeated a very similar process to the one that was conducted by the banks and state funds in earlier years. Even before the process was finished, research conducted by the Ivo Pilar Institute of Social Sciences showed that the idea inspiring managers of investment funds was the concentration of ownership rights in a particular company and then the selling of those assets to a strategic investor, who was to accomplish the company’s restructuring (Cengic 2001, p. 103). It might be a rational approach, although it clearly contrasts with the idea of the development of popular capitalism, which was the purpose of those who advocated the distribution of vouchers in other countries.

Again, market allocation didn’t take place: the price of shares and the performance of companies weren’t significant for the exchange that followed the distribution of vouchers (SAORPV 2003). Among more than 471 auctioned companies, 281 were insolvent or unprofitable, though the law explicitly forbade that such companies should be offered in return for vouchers. Later, after the auctions and the initial allocation of entitlements of ownership, privatisation investment funds exchanged shares in insolvent companies, which they had collected, for the shares of other companies in the ownership of the Government. This confirms that the auctions were senseless: PIF’s competed for shares without checking on the performance of the companies, and when they later discovered the figures in profit and loss accounts they exchanged their worthless shares for new companies in the state’s ownership. Priority was given to the concentration of ownership, not to the price of the shares. The State Audit Office explicitly states that the responsible governmental body “didn’t conduct an evaluation of shares given in exchange” (SAORP 2003).
Privatisation investment funds were listed on the Zagreb Stock Exchange and were obliged to report their performance. Because the assets under their management were predominantly illiquid, manipulation of the reports was routine, as was the trading of their shares. The founders of funds and fund managers had purchased the shares of funds from those who invested their vouchers in them. Finally, fund managers, in a carefully chosen moment, pushed through legislation that opened the possibility for investment funds to transform themselves into holding companies. The outcome was that the establishers and managers of funds ended up as the owners of companies, although it was initially declared that they would simply collect a fee for asset management, while the recipients of vouchers would enjoy the proceeds of the investments. It seems that the complaints of voucher owners were less strong than the complaints of individual shareholders in the first round of privatisation, though this process of voucher privatisation in the end very clearly exhibited the main attributes (and deficiencies) of Croatian privatisation.

5. Brief comment

According to Waldron’s definition, initial appropriation includes that an agent by his sole action of acquisition of resource imposes a duty upon others (to refrain from using “my” thing) without their prior explicit consent (chapter II, section 3.4 The distinctive feature of initial appropriation). I have argued that the process of the concentration of ownership that followed the initial allocation of shares should be interpreted as an initial appropriation. One may argue that the concentration of ownership was not a sole action; it was a result of a joint endeavour of various big shareholders who – among themselves – exchanged large stocks of shares, which were already in their possession. The government’s directives and theoretical ideas argued that the purpose of the concentration of ownership was an improvement of the governance of resources.

However, the destiny of employees who gave up their shareholdings shows the absence of explicit or implicit consent. It is true that the concentration of ownership mainly wasn’t a sole action of an individual. Nevertheless I would say that this was a sole action of two or more people, of a group of people, or even an activity of a social elite, managers, bankers and politicians, without consent of another large group of people, which also might have claimed their ownership rights if a different procedure, open to all, had been organised. An absence of the pricing of stocks confirms the lack of consent and the lack of a transparent procedure. The tunnelling of companies, which might be understood as a process
of enforcement of property rights (chapter V, section 3.2), was a consequence of the destructive race for resources, comparable to Lueck’s analysis of first appropriation. The question whether the process of concentration of ownership was fair or not was frequently discussed. Various social groups used arguments analogous to Lockean spoliation and sufficiency provisos as well as the principle that the resource belongs to those who created it or who improved it. In my opinion the above described development was supported, at least indirectly, by the theoretical understanding of property that claimed that social ownership was nobody’s property; that the unified bundle of property rights (and not dispersed shareholding) represents ownership; and that all the exchanges will, at the end, reach an equilibrium which signifies that the resources were placed at the position of their most efficient use.

The lack of legal protection of ownership was the characteristic of privatisation in Croatia commented upon most frequently. It was already mentioned that the State Audit Office conducted an examination into possible infringements of the privatisation laws. According to the Report that was submitted to the Parliament three years later infringements of the law were identified in roughly 90 percent of the sample of companies (SAORP Final 2004).\(^\text{36}\) Advocates of Croatian privatisation emphasised that 90 percent of the infringements were minor wrongs without any substantial influence on the outcome of the process (Skegro 2007). The findings – according to supporters of privatisation – actually show how low the quality of administration in the companies was, and how negligent was the state administration inherited from the socialistic regime. However, blaming the negligent socialist administration is not an adequate excuse. The design of the process of privatisation should have taken into account the capacity of the judicial system, and inherited customs and habits. North emphasises that inherited informal norms often prevent the implementation of a new legal regime (North 1990). It takes time for a system to create procedures for the protection of shareholders. Croatian economists appreciated the importance of formal and informal norms only later.

Individual shareholders encountered the problem of investigating the attributes of their holdings and the costs of enforcing their property rights. The procedures

\(^{36}\) The sample wasn’t representative but it was large. The State Audit Office investigated the process of privatisation in roughly 1500 companies following formal complaints of individuals and organizations. Therefore, the privatisation of these companies was considered suspicious. However, this doesn’t imply that the process of privatisation was conducted correctly in the remaining more than 1000 companies.
for the protection of the value of their holdings which they used under the
system of self-management weren’t available to them any more, since ideological
propaganda accused them of being remnants of the previous system. The blaming
of the socialist administrative structures for the outcome of the program belongs
to the same framework: as if the design of privatisation was perfect but the people
for whose benefit it was designed didn’t deserve it. In my opinion neither the
difficulties of the legal enforcement of property rights nor the inherited informal
norms were the only cause of the outcome of the process of privatisation in
Croatia. The bigger problem was that the model of privatisation didn’t anticipate
these challenges, since they didn’t belong to the accepted understanding of how a
capitalist economy emerges and how it works.

Though the concepts of the economics of property rights look very abstract, it
is easy – in my opinion – to apply them in the case of privatisation in Croatia.
The allocation of legal rights doesn’t imply the acquisition of economic property
rights. Even if the administration had worked perfectly, it would have taken a
time until citizens and workers collected and processed appropriate information
to decide what they could do with their holdings. When legal rights were allocated
to the shareholders, they were legally equal, but their economic rights weren’t
equal: the positions of management, bankers and members of the ruling party
were superior since the transaction costs for them were lower, i. e. the costs of
collecting information, the costs of negotiation and of making alliances. The
ideological propaganda for an unfettered market, which was proffered by the
Croatian economists, served to obscure questions that might otherwise have been
raised about such issues.

As a consequence of tough discussions between the representatives of particular
social factions the original Law on the Transformation of Social Ownership was
amended six times. Significant discounts that were given to particular social
groups should be understood as side payments. Nevertheless, a number of
surveys show that the Croatian public was greatly disappointed with the process
of privatisation and its outcomes. It was considered theft, robbery, “the biggest
crime of the 20th century” or, at least, an unfair and unjust process (Skegro 2007).
The survey to which I am referring, which was conducted in 1989 by the Institute
for Social Research of the University of Zagreb, shows that private property and
competitive elections were favoured by 68 percent and 85 percent of the elite
respectively, while 55 percent of the total sample supported both mentioned
choices (Kristofic 1999). That means the population at that time was not against
the economic and political transition. Research also shows that Croatian social capital (collective norms and customs inherited from the previous regime), wasn’t a significant barrier to the privatisation process (Stulhofer 1999), at least at the beginning. Fifteen percent of the population subscribed to shares in the first wave of privatisation, which is a significant fraction. Privatisation in Slovenia, in other transition countries, or in the UK are often emphasised as positive cases, which implies that the people were not against the system of private property, but privatisation in Croatia was largely negatively assessed (Cuckovic 1999). The surprising result of the research, which was conducted nearly ten years after Croatia overwhelmingly and peacefully discarded socialism, was that 35 percent of people assessed self-managed companies to be more successful than those that were privatised, while only 15 percent of the sample concluded privatised companies to be more successful (Cengic and Rogic 1999, p. 96). It indicates how the disappointment was both strong and deep. However, people thought that the process wasn’t fair and the result wasn’t an economic success.

The problem might be - using the Libecap's terminology - the divergence between the expected aggregate gains and what was achieved, between hopes and reality. The highest priority concerning privatisation, for 90 percent of the people, was security of employment. On the other hand, economic growth as a goal of economic transformation was emphasised among economists. One might ask here: was the problem, at bottom, the performance of the privatised companies, or did it relate, rather, to the predatory manner in which privatisation took place? In my opinion this question can be answered and the process of privatisation in Croatia can be much better assessed after comparison with an analogous process in Slovenia, which is a neighbouring country that inherited the same system of property rights but which conducted a different approach to the transformation of self management and social ownership. This is the subject of the following chapter.
Chapter VIII

Privatisation in Slovenia; Comparison to Croatia

The subject of this chapter is privatisation in Slovenia. Issues that are comparable to the Croatian case will be particularly emphasised. Croatia and Slovenia are neighbouring countries that share a common history. Both countries were parts of the Austro-Hungarian Empire and of Yugoslavia and both declared independence on the same day. Both countries encountered the same problem of "two-fold transition". In addition to the transition from a socialist to a market economy, Slovenia and Croatia belonged to the group of countries that faced the transition from a regional economy (as parts of Yugoslavia) to a national economy. Both countries were to introduce new national currencies; in both countries the property regime to be transformed was the same – self-management and social ownership. Additionally, Slovenia is an especially appropriate “a point of reference” for the Croatian privatisation. In addition to sharing so much in common with Croatia, it also exhibited some interesting differences: it is the most successful transitional country; Slovenian membership in the EU was almost never challenged - neither of the formal EU-documents reported a substantial lag on the Slovenian accession path.

At the same time, the transition from socialism to capitalism in Slovenia has been full of controversies. Slovenia was the most developed socialist country, but privatisation in Slovenia, measured by the formal distinction between state-ownership and private ownership, was the slowest among the countries of the first tier of transition (the most progressive countries). This didn't stall or slow down Slovenian economic growth substantially. However, we don't

\[1\] In the chapter about the first phase of privatisation in Croatia the Transition Report issued by the European Bank for Restructuring and Development from 1997 was quoted (TR 1997). According to this and other similar reports privatisation in Slovenia was the slowest among the neighbouring countries and it remained the same for years.

\[2\] This was an informal but very common categorisation. The countries of the first tier according to their capability for membership in the EU were Hungary, the Czech Republic, Estonia, Poland and Slovenia.
know what would have happened if its national assets had been 100 percent privatised, but we do know that Slovenia is the most developed of the former socialist countries even today. Measured by GDP per capita Slovenia is a little more developed than Portugal, approximately at the same level as Greece and a little less developed than Spain. Hence, Slovenia is an average country of the Northern Mediterranean.

The low level of foreign investment in Slovenia was notorious and even direct and strong formal barriers to this were imposed. At the same time, measured by international trade in goods and services, the Slovenian economy was among the most internationalised. It was the same under socialism; Slovenian companies cooperated intensively with foreign partners. The population of only two million people have been very active in investments and business abroad nowadays, especially in the republics of the former Yugoslavia.

Income (and wealth) distribution in Slovenia is “among the most equal among the transition economises” and is similar to the Scandinavian countries (Mrak et al 2004, p. 7). Slow privatisation, barriers to foreign investments, high protection of labour, an active welfare policy, emphasis on equality and an insistence on prudence in both economic and institutional reforms, were frequent arguments that were advanced to the effect that Slovenia was abandoning its socialist legacy only half-heartedly. In contrast to such claims, Slovenia emerged as the front-runner in the process of accession to the EU among the formerly socialist countries. In comparison to these other countries, Slovenia rather easily fulfilled the macroeconomic criteria for the EU membership and other institutional requirements to be assessed as “a functioning market economy”, and Slovenian companies were considered to be capable of competing in the common European market. After she became a member of the EU, Slovenia was the first formerly socialist country that adopted the euro as its domestic currency. Due to the fact that membership in the EU symbolically marks the end of transition (Cuculic 2002)

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3 Croats believed that their country at the beginning of transition followed Slovenia: “Croatia, the second wealthiest republic of the former Yugoslav Federation after Slovenia, was one of the most developed and ‘westernised’ socialist countries. It was well in the category of medium wealthy countries and its development indicators were next to the levels of OECD countries.” (Vujcic & Lang 2002)

4 When it was necessary Slovenia restricted its fiscal deficit on a level lower than 3 percent of GDP and even reported a surplus in some years, its public debt is low as well as the inflation rate. Moreover, Slovenia fulfilled the Maastricht criteria of convergence, while some other old members of the EU don’t follow the criteria consistently.

5 This was explicitly stated in numerous Progress Reports issued by the European Commission.
I think it would be very instructive to compare Croatia with Slovenia. This chapter is also an implicit comment upon previous chapters on Croatian privatisation.

1. Plan of the chapter

The subsequent description of privatisation in Slovenia follows the same structure that was employed in the description of privatisation in Croatia. I will initially give a brief account of the political environment in Slovenia; for easier understanding I will provide a comparison with Croatia (section 2). A comprehensive description of the privatisation debate follows (section 3), then a detailed explanation of the initial allocation of assets (section 4) and of the secondary privatisation on the financial market (section 5). Throughout the description of the process of privatisation in Slovenia I will sporadically emphasise the distinctions of paths and approaches between Croatia and Slovenia.

In the next chapter I will try to draw some lessons from Slovenian experience with privatisation. I will examine my hypotheses, that the insights developed within the economics of property rights were taken into account in Slovenia and that the transformation of the property regime in Slovenia was an example of the evolution of property rights (in contrast to the Croatian approach where privatisation took the form of an initial appropriation). Finally I will compare the structure of company ownership after privatisation and its economic results in Slovenia and Croatia.

2.1 Political environment

In Slovenia the transition was initiated and conducted by the former political elite: “[T]he old elites not only anticipated the transition but, by introducing important changes already in the pre-transition period, also influenced their own future position in the society and economy in the aftermath of transition.” (Mrak et al 2004, p. 4) The last leader of the Slovenian communists, Milan Kucan, won two consecutive elections for the President of Slovenia. In the last two decades of socialism, powerful civil society organizations (greens, feminists, peace and human rights activists) persistently challenged socialist dogmas (Likic Brboric 2003, p. 167). They were supported by the official Slovenian Organisation of

Kucan is a kind of Slovenian Mikhail Gorbachev, a reformist who in contrast to Gorbachev was successful, was tolerant and was favoured by the public, like Vaclav Havel was in the Czech Republic. He was succeeded by another communist cadre, Janez Drnovsek, who was the Prime Minister of Slovenia during the 1990’s and had been the last Slovenian delegate in the Presidency of Yugoslavia. For one year, in his forties, Drnovsek served as the President of Yugoslavia.
Socialist Youth, from which later emerged the Liberal Democratic Party. This party won the highest number of parliamentary seats among all parliamentary parties in the first multiparty elections.7

### 2.2 Pluralistic vs. autocratic rule

Politically, the most important differences between Croatia and Slovenia were manifested in the outcomes of the first multiparty elections. In Croatia the majority of Parliamentary seats were won by the Croatian Democratic Union (HDZ), and it paved the way for the authoritarian rule of its leader Franjo Tudjman. In Slovenia, the majority was won by a conservative six-party coalition in two chambers8 while a third chamber was dominated by “the old transformed political actors and interest groups” (leftists)9. Consequently, it was not possible to limit discussion and decisions about the transformation of the property regime and all other issues relating to transition to a closed circle at the top, like in Croatia, but political debate and determination were much more transparent and decentralised.

“A special feature of Slovenia was that it was able to retain a strong middle class (practically the only one among transition economies) as a foundation for political stability” (Mrak et al 2004, p. 7). In my opinion, the fact that the old elite in Slovenia was neither wiped out, nor ultimately required to surrender to the new forces, confirms the tendency toward consensus and tolerance in the small, close-knit Slovenian community which enabled the Slovenian transition to take on the character of social evolution instead of revolutionary change. The battle

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7 One must be cautious about the thesis of the survival of the old elite in Slovenia as an exclusive cause of success. Whether the thesis was correct or not depends on circumstances and especially on the values that are promoted by the elite. In Serbia, as well as in many other countries of former socialism, the old elite retained power but didn’t change its behaviour. The survival of the elite in these countries was the explanation of their failures. In Croatia, the reformed communists lost the elections, but a large fraction of the new ruling party were former orthodox communists who were expelled from the Party during the 1970s as advocates of nationalism.

8 DEMOS was a six party coalition (Christian Democratic Party, Slovenian Farmer Union, Slovenian Democratic Alliance, Social Democratic Union, The Greens of Slovenia, Liberal Party – Craftsmen Union). It was also called a right-left coalition, because its members included the Christian Democrats and the Social Democrats. The political positions weren’t yet precisely defined, but in essence the DEMOS were the parties that were inclined to traditionalism and national greens (protection of nature in Slovenia). The coalition won a majority in the Socio Political Chamber and in the Chamber of Communes and Municipalities.

9 While farmers and craftsmen were closer to the traditionalists, in the Chamber of Associate Labour representatives of the business community and unions were elected (Likic Brboris 2003, p. 174)
between the new elite and the old one was in Croatia much harsher, though people regularly changed sides, jumping into new parties. I will discuss this point further in the next chapter.

2.3 Respect for institutions

The next point I would like to emphasise here concerns the rule of law and the decentralisation of administrative power. In many countries of former communism the old institutions usually lost their power while still being formally active, especially if the old cadre ran them. For example, the old unions in Croatia, while still in existence, didn’t enjoy respect in the discussion about privatisation. In Slovenia things worked quite differently: there, official responsibilities were strongly respected. Therefore, the opinion about privatisation, issued by the Social Advocate for Self-Management, while that office was not yet dismantled, was respected by the Government and the Parliament, as were the opinions of the Unions (Likic Brboric 2003, p. 213). In Croatia that kind of discussion was routinely rejected as the propaganda of old communists.

Finally I would like to complete the discussion about the institutional differences between Slovenia and Croatia by adding a fact that Slovenians also consider important: “The relatively homogeneous national [ethnic] structure most likely prevented Slovenia [from] becoming involved in a devastating war as did other former republics of the former Yugoslavia.” (Prasnihar et al 2001, p. 4) I think that this fact should be mentioned; nevertheless it doesn’t excuse the leaders of communities in other former federal units for their damaging policies concerning ethnic relationships.10

3.1 Two methods of privatisation

The two methods of privatisation that were proposed in Slovenia were different from the two methods that were discussed in Croatia. It is not easy to classify them, because both methods were extremely complex. My concern here is not to provide a detailed description, but rather to concentrate attention on the arguments that were used to support particular proposals and on the points that were important for the outcome of privatisation. The distinction between the method of selling and the method of distribution of assets - which was the most heated topic in Croatia - is not essential here. The method of selling basically

10 Multiethnic Macedonia avoided the war in the 1990s after the dissolution of former Yugoslavia.
assumes public auctions of large stocks of ownership. It reduces the chances for average individuals to take part in the process. In Slovenia, both proposals that were considered were variants of mass privatisation, i.e. both methods assumed that individuals (employees and citizens) should be included in the process. The first method was based on selling the assets of socially owned companies with a substantial discount to insiders (management and employees). It was supposed that the residual equity would be transferred to the Development Fund and later offered to both insiders and citizens. The second method was the distribution of assets to citizens through a voucher scheme, using privatisation investment funds as intermediaries.

The first method is much more important for the purpose of comparison of the processes in Croatia and Slovenia. A key distinction between the two methods proposed in Slovenia was, in my understanding, that the second one, voucher distribution, was designed so that it could be applied in any country of former socialism, or in any other country having state owned or public property. This would apply equally in Slovenia and Croatia, where the earlier regime was social ownership and in the Czech Republic where assets were owned by the state. As opposed to this, the method of privatisation by means of preferential sale to employees and management proposed the creation of a new property regime on the basis of the existing system of self-management and social ownership.

I have already quoted Mencinger (2001, at the beginning of chapter I), who was the main proponent of insider privatisation in Slovenia, to the effect that the method of free distribution (of shares or vouchers) neglects “genuine variations in the endowments of individual countries, including their political and social environment, their respective institutional frameworks, [the] degree of monetization of their economy, [their] industrial structure, [and] their mode of incorporation into the world market, or macroeconomic performance”. Mencinger emphasises that exactly these factors must be respected “if economic and social costs of the transition were to be minimised” (2001, p. 453, emphasis in the original). The proposal created by Mencinger and his contributors Uros Korze and Marko Simonetti respected the existing ownership regime rather than neglecting it.¹¹

¹¹ At the time when the proposal was launched, Mencinger, a respected university professor, was Deputy Prime Minister responsible for economic matters, Korze was a head of the Development Fund (a Governmental agency) and Simonetti used to work as an expert for the last Yugoslav Government which enforced the federal insider privatisation.
3.2 The method of insider-privatisation

Explaining his method of privatisation, Mencinger (1992) explicated which specificities of the existing property regime he considered substantial.

- The achieved independence of companies. This point implies that companies under the system of self-management already enjoyed significant autonomy in business matters.\(^{12}\)
- The regional spread of Slovenian industry.
- The close relationship of companies with foreign partners.

According to Mencinger, firms employing between 100 and 500 people constituted the bulk of socially owned businesses and were dispersed throughout the country. His proposal was aimed at strengthening the bonds of the employees with their “own” firm and at diminishing the social costs of transition (Mencinger 2001, p. 458). This proposal relied on the assumption that the population of Slovenia was relatively wealthy on average, having financial resources in foreign banks and domestic mattresses. Mencinger strongly insisted on the selling and not the distribution of assets without compensation. He believed that the Slovenian population was wealthy enough to participate in the process, but he obviously wasn’t sure about this assumption. Mencinger proposed a gradual buying of companies; a possible lack of money wasn’t considered a barrier for the selling of equity to insiders.\(^{13}\) If management, employees and their partners didn’t succeed in the purchase of the entire equity subject to privatisation, the residual fraction was to be transferred to the Development Fund. It was proposed that those who had already taken up some shares would be obliged to purchase an additional 10 percent of the residual shares every year. If employees and management failed to do this, the Fund might sell the residue. It was not supposed that the shares transferred to the Development Fund should carry ordinary voting rights, but only a veto-right in special cases stipulated by the law. Consequently, the proposal supposed that the insiders would run the company, even if their fraction of ownership was smaller than the fraction owned by the state. The money collected from the selling of socially owned equity was to be transferred “to the Development Fund to be used for pensions and disability insurance, social development and

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\(^{12}\) This was the case in Slovenia, but not the same in other federal units of former Yugoslavia.

\(^{13}\) Croatian economists estimated that the total savings of the Croatian people could purchase only 10 to 20 percent of companies that were in social ownership, and this was one of the key arguments against the selling proposal and for the method of distribution.
environmental programmes, restitutions [the compensation of former owners of nationalised companies] and repayments of debts.” (Mencinger 2001, p. 458)

Basically, the first Slovenian privatisation proposal supposed that management and employees would purchase equity in their company at a significant discount. There was also the possibility for a debt equity swap and the possibility of issuing shares for the purpose of raising additional capital. The last two options supposed the inclusion of foreign partners in the ownership transformation, but this was to be decided by the company.

The proposed method of privatisation was in fact an elaborate variant of the method that has already been described as Horvat’s proposal in chapter V, in my discussion of the Croatian privatisation debate. The proposal was widely discussed and even those participants who generally supported it raised some substantial objections. The creators of insider privatisation accepted the inappropriateness of their model for the privatisation of loss-making companies. The proposal was also problematic in the case of the privatisation of highly capitalised and highly profitable companies. The insiders’ scheme opens the possibility that workers (and management) - in the case when they own a minority of equity, but control the management of the entire company - siphon off the assets through various schemes, and at the expense of outside owners. The description of the second phase of privatisation in Slovenia will show that the problem of asset stripping at the expense of other investors might be temporarily attenuated by market regulation.

The proponents of the competing voucher proposal focused their criticism on the question of whether the insiders in this conception were understood as transitional, temporary owners, who search for strategic partners or as final owners. In the case of the former, the question was raised as to how it could be justified that exactly the “red directors” get the right to search for strategic owners and a new, more efficient ownership structure. At this point the discussion became openly ideological.

Branka Likic Brboric (2003) distinguishes “the old” and “the new” political and social actors in regard to the discussion of privatisation in Slovenia. Among “the old” actors were reformed communists, old unions (new unions were also established) and management associations, while the new political parties and the Association of Nationalised Owners (owners of assets that were nationalised
during the period of socialism) were recognised as new social and political forces. Almost all institutions included in the discussion - political parties, unions, associations of managers etc. - demanded the distribution of some portion of assets to workers and citizens (Likic Brboric 2003, pp. 220ff.). Exactly this, a distribution of social assets using the method of vouchers, was the essence of the competing proposal.

3.3 The method of voucher-distribution

The method of distribution of vouchers was discussed in Slovenia from the beginning of 1990, as well as in other transitional countries, but the economic section of the Slovenian Government, which launched insider privatisation, rejected it without detailed analysis. Nevertheless, it seems that the voucher proposal was very attractive. It came back into the discussion as a dominant idea after harsh criticism of the insider proposal. According to former owners of nationalised property, many of them emigrants from Slovenia after WWII, the insider proposal neglected the principle of the protection of private property as “a human right,” claiming that they were robbed when their assets were nationalised; also, they questioned the efficiency of companies managed by “Marxist-trained businessmen” and workers. This criticism, supported by some parties in the ruling coalition, initiated a serious redesign of the initial privatisation proposal. Its creator and promoter, Vice Prime Minister Joze Mencinger, resigned. In cooperation with the American economist Jeffrey Sachs, Prime Minister Peterle launched a proposal for privatisation in which voucher-distribution of assets dominated. (As for the former owners of nationalised property, a restitution fund was proposed.)

It must be recognised that the voucher proposal sharpened discussion about two essential criteria of privatisation: justice and economic efficiency. The final goal of the process was to be an increase in the efficiency of companies. It was to be a consequence of an adequate ownership structure; this is why the existing ownership structure was to be transformed. The insider method of privatisation relied on a step-by-step improvement of the existing ownership structure. It proposed a gradual introduction of legal for merely economic ownership, and of the limited transferability of ownership rights. In addition to the objection that this type of initial allocation of resources was not just, much more powerful was criticism that placing assets into the hands of insiders creates impediments for further development toward an optimal ownership structure. In my opinion, the
main contribution of the voucher proposal in Slovenia was the introduction of discussion about the optimal ownership structure.

### 3.4 Company and ownership

I will select here four points of controversy between two proposals that express two different views as to what was the optimal ownership structure for Slovenian companies, and how to achieve it.

1. The voucher proposal favoured outside (external) owners over insiders. The inherent inefficiency of workers’ cooperatives was emphasised.\(^{14}\) Very often it was expected that foreigners would emerge as the optimal (the most efficient) investors if there were an optimal design of privatisation and an open, unrestrained capital market.

2. The distinction between financial investors and strategic investors was discussed.\(^{15}\) The advocates of insider privatisation insisted that Slovenian companies also need strategic investors. According to them, direct negotiation between companies and potential investors was a method more suitable to the process of privatisation in Slovenia than a long-term development of a capital market. Slovenian companies had had experience with strategic partners from abroad before; as for a market for securities, it was argued that this takes time to be developed to the level at which events on the capital market might positively affect the restructuring of companies.

3. The discussion about the design of a capital market was concentrated around a controversy as to whether an expert evaluation of the price of equity to be privatised was necessary or not. The voucher proposal jumps over this step and claims that such evaluation was to be left to the market.

4. The insider method insisted on the autonomy of the company, claiming that a certain degree of this has been achieved under socialism, while the voucher proposal basically neglected this issue.

The essence of the insider proposal is point four. If it was accepted, then other points are easy to resolve. The company (management and employees) would approach other investors (banks, potential strategic partners) open its books to the potential strategic partner or financial investor (dispersed or concentrated)

\(^{14}\) I discussed this point in chapter IV, about self-management.

\(^{15}\) Financial investors were understood as those who place their money into purchasing shares of a company expecting that their market price will rise, while a strategic investor effects necessary restructuring of the company.
so as to enable the evaluation of its assets; incumbent owners would resolve the dilemma over whether an outside investor is necessary at all. However, things, in practice, would not be so simple. The advocates of the insider scheme were aware of the possibility of manipulation and corruption in the case of expert evaluation of the prices of equity. The sections on “informal privatisation” and the secondary privatisation will discuss this issue further.

The advocates of voucher distribution supposed that their method “avoids the problem of evaluation” (Likic Brboric 2003, p. 273); this implied that the voucher method overcomes the problems of possible manipulation and corruption, which was perceived as very widespread under socialism. The Croatian experience and the processes in other countries contradict the expectation of proponents of the voucher proposal, that an absence of evaluation would increase the speed of the process of privatisation. I discussed this idea in chapter V, about the privatisation debate in Croatia (section 4.2: The market without information). The lack of information rather restrains the intensity of market transactions and – consequently – may cause an inappropriate evaluation of the value of assets to be exchanged. Rather it looked as if the absence of evaluation stalled transactions on the capital market. How Slovenia confronted this problem will be discussed in the section about secondary privatisation. The advocates of insider privatisation argued that the evaluation of assets is crucial for the success of mass privatisation. The conclusion that further market transactions would set up their own evaluation of capital doesn’t preclude a prior expert’s evaluation, which basically increases the amount of market information, although it is fallible, and also vulnerable to manipulation and corruption.

3.5 Towards a compromise

Almost all formal and informal institutions related to the process took part in the privatisation debate in Slovenia: political parties, the press, unions, associations of managers and professional associations as well as academics. Slovenia organised round tables on privatisation and also international symposiums. Both approaches to privatisation, the insiders’ method and the method of distribution of vouchers,  

16 A theoretical basis for the conclusion that the market cannot, by itself, overcome a lack of information was advanced in Akerlof (1970). However, market participants may introduce various methods of overcoming the problem with market transactions that could not take place because of a lack of information, for example the introduction of certificates and licences, the bulding of reputation and so on. The importance of information for market exchange is discussed in the section on the Coase Theorem (chapter III)
enjoyed support from abroad and from international financial institutions. David Ellerman a World Bank economist, who used to work on the development of the ESOP scheme\(^\text{17}\) in the United States, cooperated in the preparation of the insider proposal, believing that workers’ ownership might influence an increase of efficiency in the company. Jeffrey Sachs, who was the economic adviser of the last Government of the Federal Socialist Yugoslavia, advocated the voucher scheme in Poland and also in Slovenia. Richard Layard from the London School of Economics believed that the voucher scheme overcomes the problem of valuation. Cento Veljanovski (Institute of Economic Affairs, London) was suspicious whether investment funds could be appropriate owners of former self-managed companies (Likic Brboric 2003, p. 273).

The discussion discovered a lot of weak points in both proposals. The participants in the discussion and the public became aware of this. The discovered difficulties and malfunctions of both proposed methods caused very slow and careful enforcement of the legislation of privatisation in Slovenia. In contrast to the Croatian “anything goes” approach, it looked as if in Slovenia, “nothing goes”; international analysts interpreted the long and exhaustive discussion as indicative that Slovenia was reluctant to conduct ownership transformation and, as being a symptom of the unwillingness of Slovenians to give up socialism. Among the countries of the first tier of transition, Slovenia was the last that enforced privatisation.

### 3.5.1 Informal privatisation – Tunnelling

There was a downside to the slow transformation of ownership rights in Slovenia. During the almost three years of discussion about the privatisation bill, informal and indirect privatisation continued. As early as 1990, the Slovenian economist Bajt (1990, p. 351) warned about the necessity to improve the rules that penalize disloyalty to a company. Mencinger (2001, p. 461) explained: “Most often, managers established a company owned by themselves or by their cronies and transferred the most profitable activities to the new company, [and] sold assets to the new private company below market price...” I have already described this practice of asset striping (chapter V, section on Tunnelling), which was widespread across transitional countries and which was possible in Croatia and Slovenia under the circumstances of the coexistence of social ownership and private ownership that was introduced in the last years of Yugoslavia.

\(^{17}\) ESOP – employees stock ownership program
The analysis of bankruptcies in Slovenia (Znidarsic Kranjc 1993) at the time of the privatisation debate indicates that crime, theft, cheating, and the transfer of business activities to other companies - i.e. informal privatisation - were recorded as the real cause of bankruptcies, besides “normal” bankruptcies that were consequences of economic crises or sudden weaknesses of demand. But the cause of an even larger fraction of bankruptcies was bad management typical of socialism, over-expenditure and negligence. Therefore, the transfer of assets to other companies - where they would be improved - was sometimes a form of restructuring. It is important to emphasise that employees (rather than just managers) very often participated in the process of spontaneous privatisation. However, there were again the issues of fairness toward others who previously participated in the use of resources that were socially owned, and the problem of the efficiency of the use of resources that were spontaneously privatised. Due to the close monitoring by the public, spontaneous privatisation in Slovenia was conducted lawfully and gainfully, from the economic point of view, as much as possible. This conclusion relies on an analysis of companies established in the period between 1989 and 1992, i.e. before the Privatisation Law. Employee ownership was found in almost 13 percent (400) of the firms in the sample, and in hundreds of companies, foreign ownership was detected. The phenomenon confirms that privatisation was a promising option in Slovenia, that employees and foreigners, i.e. the foreign business partners of Slovenian companies, were very willing to participate in it, and frequently they were willing to privatise together. foreigners often expected that employees would forever retain some (controlling) stake in ownership. The above-mentioned analysis has shown that both foreign and employee ownership improved the performance of companies.

18 Bankruptcies of a hundred companies were analysed, which was 65 percent of all bankruptcies from 1989 to 1991.

19 In Poland the transfer of assets to another company was an official form of privatisation. The prerequisite was that at least 50 percent of employees should take part in the undertaking.

20 From the total sample of more than 22,000 companies registered in the period between 1989 and 1992, i.e. before the Privatisation Law, the authors firstly excluded those with no employees and no capital. Then from the remaining almost 5,700 firms more than 2,900 firms were randomly selected. Employee ownership was found in almost 400 firms (13 percent), and foreign ownership was analysed in 80 companies. In 50 companies from the sample coexistence of foreign and employee ownership was registered. (Smith et al 1997)

21 It must be taken into account that ownership is not an exogenous variable in the performance of companies. That is, the future owners chose to take over more successful and more promising companies. The above analysis by Smith, Cin and Vodopivec (1997) has found that foreigners were more successful than employees.
However, the authors concluded that the process of spontaneous privatisation encountered significant transaction costs. New legislation on privatisation was to open up possibilities for the further development of the ownership structure. This insight and consciousness of the weak points in both proposals opened the door for compromise. The design of the voucher proposal in its final Slovenian variant accepted the autonomy of companies to some degree. It was assumed that small companies would prepare their own programs for privatisation; a portion of the ownership in companies of medium size was to be allocated to insiders, while large companies were to offer their entire equity to the owners of vouchers (certificates). Some large companies aimed for a direct sale to strategic investors. The final version of the law allowed for all these different options.

4. The privatisation scheme and its initial results

The chosen method of privatisation was a clear compromise that emerged from the discussion. At the end of 1992 the Law on Ownership Transformation was passed by Parliament. Similarly to the Croatian case, public services (public companies), banks and insurance companies, firms in the process of bankruptcy, etc., were excluded. The more than 1500 firms selected for ownership transformation employed 50 percent of the labour force in the business sector. Firms were given a long period to prepare the program of privatisation autonomously. The Governmental Agency for restructuring approved the first program in the middle of 1993, while the last approval was given at the beginning of 1998 (Prasnihar et al 2001, p. 44).

This extremely complex method of privatisation will be presented here with - possibly - too many details just because we need to have before us a correct and comprehensive documentation of the process. Later, I will emphasise the characteristics that I consider important for my overall argument. Assets were divided so that:

(1) 20 percent was transferred to para-state funds; half of it to restitution funds, and the remaining 10 percent to pension funds;

(2) 20 percent was available to various mutual funds (privately managed privatisation funds), which were to compete for the ownership certificates distributed to citizens (under a voucher scheme) and subsequently to participate in public auctions;

22 This fund was to compensate the owners of nationalised companies.
(3) 20 percent was to be exchanged for workers’ certificates (insider scheme).

(4) Four options were available for the privatisation of the remaining 40 percent:
   • buy-outs on favourable terms by internal owners;
   • public sale by tender (by strategic investors);
   • internal buy out (by insiders);
   • the public sale of shares (the owners of vouchers and the investment funds which collected vouchers were possible buyers).

The raising of additional capital was also possible.

The certificates (vouchers) were initially allocated to all citizens of Slovenia. One possibility for them was to participate in public auctions personally and another option was to transfer their certificates to the privatisation funds. In six years, more than 1300 companies successfully completed their ownership transformation; more than 90 percent chose the internal buy out, that is, they were privatised by insiders. Those were predominantly smaller firms. As to larger firms, in 6 percent of firms that managed 30 percent of the capital, insiders acquired less than 10 percent. Privatisation funds acquired one fourth of the total capital aimed at privatisation; one fifth went to state funds, while 13 percent was publicly sold in exchange for certificates (vouchers) (Prasnikar 2001 p. 44).

The privatisation scheme clearly attempted to satisfy both extreme proposals – insider privatisation and voucher privatisation, though an advantage was given to the insider-proposal. The autonomy of companies was a dominant, although not the absolute, principle of ownership transformation. A fraction of assets was allocated to the former owners of nationalised property, and another fraction to a Pension fund that was managed by the Government. On the supply side, the auctions at the official stock exchange were organised by companies or by the Development fund; namely the 20 percent intended for voucher privatisation (see point (2) above) was initially transferred to that fund under the control of the government and then, after the auction, to the privatisation funds or to citizens in exchange for certificates. This is what was referred to as a ‘privatisation gap’: the privatisation funds at the beginning collected a large volume of certificates but there were not enough assets on the supply side. In time that gap was filled with the new companies that had completed their privatisation program and with other assets owned by the Government. The vouchers owned by citizens
or privatisation funds were exchangeable for bonds issued by the state-owned pension fund (Simoneti and Böhm 2001, p. 7). The most complicated part was the optional 40 percent (4). It was possible to divide this fraction further, so that some percentage was to be sold at public auction; another sold as a stake to insiders or to strategic partners. Additionally, Slovenian companies faced a wide spectrum of options. From this moment on, Slovenes gradually started to learn about the tricks of a market economy.

5. Secondary privatisation

At first sight, the initial allocation of assets in Slovenia seems similar to the first phase of privatisation in Croatia; a large amount of shares were distributed to insiders (employees and managers) and para-state funds. A key distinction was that in Slovenia, all citizens participated in the voucher privatisation, which was conducted at the same time that shares were allocated to insiders and funds. In Croatia, meanwhile voucher privatisation happened only few years later (in 1998) and the recipients were clients of the ruling party (war veterans, former political prisoners and so on). One can say that these distinctions were not substantial; they can be interpreted as countries’ specificities or as a consequence of circumstances. However, much depended on subsequent developments. In both countries it was expected that secondary privatisation, i.e. a further exchange of shares on the capital market, would lead to an efficient ownership structure of companies, which was the declared purpose of the process of institutional change. I have already claimed in previous chapters, that the development of the capital market revealed the very nature of the changes of the property regime in Croatia. During the second phase of the transformation of the property regime a significant divergence of patterns of privatisation in Croatia and Slovenia became obvious. It is to be investigated which concepts of property and market lay behind these distinctive patterns.

Let us assume that the efficiency of the company depends, among other things, on its ownership structure. If this is the case, then the realisation of an efficient ownership structure depends on the initial owners and on the market for property rights, its efficiency and its regulation. In Croatia, the capital market was described as “free and not transparent” (chapter VII). In Slovenia, it was expected that the regulation should facilitate “fast secondary privatisation”, but not at the expense

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23 In chapter VII secondary privatisation in Croatia was already explained; the same process in Slovenia will be described in the following chapter.
of “transparency and fairness” (Simoneti and Bohm 2001, p. 8). It was concluded that a lack of transparency and fairness might endanger an effective corporate restructuring, which was considered a long-term goal. On the other hand it was proposed that the market should be “accessible by as broad a circle of domestic and foreign buyers as possible” (Simoneti et al 2001, p. 21). It should be noted that fairness and transparency were here basically conceived as means to an end – efficient restructuring. However, it doesn’t imply that fairness was not accepted as an autonomous value in itself; only here, this aspect of fairness that affects efficiency was emphasised. It was similar with transparency and the right to market entry.

5.1 Owners and ownership structure

The subject of the debate between the two above-mentioned methods of privatisation was, whether for Slovenian companies, internal or external owners, strategic (long term) or financial investors would be appropriate. After the first phase of privatisation shares were allocated to the following types of owners: employees and former employees, managers, privatisation funds (which collected vouchers from citizens and exchanged them for shares), para-state funds, strategic investors (at the beginning they owned only 2.3 percent of total privatised equity, while foreigners among them owned only 0.3 percent). (Simoneti et al 2001, p. 24)

In regard to ownership structure, three types of companies emerged as the outcome of the first phase of privatisation:

- **public companies**, quoted on the stock exchange; they were predominantly an outcome of public auctions; even a company initially privatised by insiders might later list its shares on the stock exchange
- **non-public internal companies**; employees hold a majority stake
- **non-public external companies**; not quoted on the stock exchange; external owners, mutual funds or strategic investors held a significant stake, even though employees can also be represented in the ownership

Slovenian economists used the distinction between listed and unlisted companies as the first criterion of categorization for the purpose of assessing privatisation. This doesn’t imply that the distinction between private and public ownership, which was a dominant motive for privatisation, lost its significance. A considerable proportion of assets were excluded from the process of privatisation and some companies that were
selected for the transformation of ownership voluntarily decided for their restructuring to occur under the guidance of the state holding company (State Development Corporation). A direct and indirect influence of the state in the companies didn’t wane suddenly after the administrative allocation of shares, but in formally privatised companies the state changed its behaviour depending on various circumstances (see, for details, section 5.3 Alliances and conflicts, below).

The distinction between public and non-public companies was considered significant for the analysis of the relationship between the performance of companies and ownership structure. Initially, one tenth of companies that underwent mass privatisation were quoted on the stock exchange. They were the largest and mainly the best Slovenian companies. Their ownership was dispersed – the state owned 27 percent of their total equity, directly and indirectly through various funds that were controlled by the Government; employees, former employees, and managers owned more than 30 percent, privatisation funds owned almost 20 percent, domestic and foreign financial investors owned more than 20 percent and so on. I do not want to bother the reader with figures and percentages but I want to note that the ownership of internal and external companies was dispersed as well.

It was reasonable to assume that a particular proportion of shares initially was allocated to so-called transitional owners, those that predominantly looked for an opportunity to exit. Further developments depended on the interests and goals of the initial owners, on the regulation of the financial market and on its characteristics, and on the purposes, values and capabilities of the regulators. Immediately after the initial privatisation Slovenia encountered all the same problems as Croatia, but the reactions were different. Several points illustrate the Slovenian choice that the capital market should be carefully controlled and developed step-by-step.

5.2 Monitoring of the market

1. In contrast to Croatia, where intensive trade was expected, a possible collapse of the capital market, immediately after the initial allocation of shares, was, in Slovenia, predicted and expected:

"Discussion on the issues of potential stock exchange collapse, inflation and the inequitable distribution of wealth began already during the drafting of
the privatisation law ... The apprehension [of] the impossibility of creating sufficient demand in the short run led to the decision to postpone [the] transferability of employees’ shares from internal distribution for two years...” (Simoneti and Bohm 2001, p. 11)

Because of the possible collapse of the stock market it was decided in Slovenia to prevent the exchange of shares and to give shareowners two years to investigate the characteristics of their holdings and market opportunities. However, such a regulation resulted in a flourishing of non-organized markets, mainly inside the companies where “managers clearly had an advantage in purchasing shares acquired by employees”. Managers or other strategic investors made contracts with the sellers about the future purchasing of the shares; however, these contracts were promptly declared illegal. Since the general public, media, professionals and interest groups closely monitored the development of the capital market, a number of regulatory constraints were imposed. I will not go into the details, but the general idea was to minimise the effects of information asymmetry and of the (ab)use of inside information.

2. The regulation of the official stock exchange tried to solve the problems of its low liquidity and high volatility of prices. Firstly, foreign portfolio investors caused - in the beginning - a stock exchange boom. Due to concerns about their potential destabilising effects, regulation was introduced that prevented them from leaving the market suddenly; the enthusiasm of foreign investors waned and the prices of attractive companies fell abruptly. Secondly, the privatisation funds collected a huge amount of vouchers from citizens, their demand for shares was strong, but it didn't match an adequate amount of shares on the supply side. There were various reasons for this shortage on the supply side: postponed transferability of shares in the ownership of employees; and, owners of particular companies who decided to wait and observe developments on the capital market.

Developments on the capital market gave an excuse to the government to postpone the privatisation of nationalised property (companies that underwent a program of restructuring); the listing of privatisation funds on the stock exchange and their transformation into standard mutual funds was delayed as well. However, this formal regulation was a consequence of intensive discussion, lobbying and the activities of agents on the capital market, which passed through a number of ups and downs in the first period of its development.
3. At the beginning of privatisation, discussion about the disclosure of information about companies was focused on whether an expert’s evaluation of the price of equity to be privatised was necessary or not. Finally, it was decided that companies should be placed on the market at their book value. However, the development of the market required an improvement of reporting upon companies’ performance. The accounting practice that was inherited from socialism tended to present a high book value for equity and not to calculate the value of capital on the basis of future cash flow that reflects the true capabilities of companies to service shareholders and potential investors. “Managers [were] slowly beginning to understand the role of dividends in corporate governance and finance. They face a trade-off between decreasing the value of capital to allow for payment of dividends and maintaining a high value of capital.” (Simoneti and Bohm 2001, p. 13) Contrary to usual expectation, if a high value of capital is reported then it was expected that a wealthy company could pay dividends to shareholders. In other words, the reporting of a high value of capital was possible if controlling shareholders (presumably employees) weren’t interested in dividends, but in retaining their employment. The changing preferences of owners and the development of the capital market mutually affected each other.

5.3 Alliances and conflicts

Different types of owners frequently made alliances and were in conflict with each other. Basically, the coordination of interests between managers and other internal owners (employees and former employees who considered themselves internal) was easiest, though their relationship wasn’t always idyllic “as the interest of managers, current and former employees were objectively different” (Simoneti et al 2001, p. 22). In contrast to former employees, current employees were interested in the security of their employment, and managers in their position. The strongest conflict was – expectedly – between internal and external owners. In addition to profit and keeping jobs, internal owners usually have an interest in the long-term development of the company. Privatisation funds, basically, were willing to cash out their ownership as soon as possible, but sometimes they tended to concentrate ownership in order to attract a strategic investor. There was no clear regularity in the behaviour of para-state funds; frequently they showed no interest in company matters; sometimes they supported internal owners, but in some cases the state was against them.
The intensity of conflict varied from company to company. Public companies suffered the fewest conflicts between owners, as both internal and external owners concluded that neither of them would come to control 50 percent of equity. It must be said again, that those were large companies and that according to the Slovenian company law, employees should be represented in the supervisory boards of companies with more than 500 employees. The fight for control was most pronounced in external companies, where none of the groups of owners held 50 percent of shares. After the first phase, internal owners on average held 40 percent while external owners (mostly funds) controlled 45 percent of the shares.

Take-over regulation was enacted only in 1997, when significant changes in the market for company control had already occurred. It became obligatory to report an increase of shareholding over particular limits, but the more important change was that two thresholds of 25 percent and 40 percent were set for mandatory bids (the duty of those who acquired more than 25 percent or 40 percent of equity was to offer to purchase shares from all the remaining shareholders.) Mandatory bids at the thresholds were obligatory for voting coalitions as well. It is distinctive of Slovenia that shareholders who had accumulated large stakes before the law was passed in the parliament were obliged ex post to make such bids.

5.4 Consolidation of ownership

Until the beginning of the year 2000, the initial number of shareholders in public companies fell by almost 40 percent; in internal companies by 30 percent, while in external companies, it fell by less than 25 percent. It is not surprising that the number of shareholders fell the most in public companies, as numerous citizens invested their vouchers in those companies with the aim of a fast sale. In contrast to the destiny of individual shareholders in Croatia (chapter VII) in Slovenia, they were compensated for their ownership. Although the concentration of ownership strengthened in all groups of companies, in public companies shareholding...

24 Slovenian analysts concluded that the regulations that they adopted were a combination of the Anglo-Saxon securities market and German company law. “But the essential ingredients of the two systems are lacking: the reliable information disclosure of the Anglo-Saxon system and the financial discipline imposed on managers and owners by the presence of banks (and strategic investors) on supervisory boards in the German system. This raises the question of the internal coherence of the regime.” (Simoneti and Bohnm, 2001, page 20)
remained strongly dispersed. Because public companies basically worked well, there was no need for investors to undertake a costly and risky take-over adventure. Foreign strategic investors would be the only candidates likely to consider take-overs, but barriers were imposed upon their free operation on the capital market in Slovenia.

Nevertheless, a lot of foreign partners of Slovenian firms attempted to establish ownership relationships with them. I have explained above that many foreigners, during the period of informal privatisation, succeeded; mostly they acquired a strategic position in smaller companies, particularly in their business partners from the period of socialism. As to their relationship with their Western partners, Slovenian companies traditionally used the so-called “fast follower” strategy: they used to work for well known foreign firms, imitate them and after collecting the experience, Slovenian companies used to approach the market independently. Filipovic (2004) describes how their foreign partners approached three bigger Slovenian companies, Lek (pharmaceuticals), Kolinska (food manufacturing), and Ljubljanske mlekarne (dairy). After a long battle Novartis (Switzerland) acquired the pharmaceutical company Lek, while the latter two rejected potential strategic partners. As a result, Kolinska suffered huge damage but survived. This shows that the attitude toward their foreign partners was not a general political decision, but rather, a product of consideration among the Slovenian public, local community and business circles.

Managers were the clear winners in the process of consolidation of ownership during the last decade of 20th century. They increased the percentage of their ownership in all types of companies. Behaving as sellers of stakes acquired during the first phase, the state and privatisation funds decreased their ownership levels; internal owners strengthened their presence in external companies; while strategic and financial investors increased their stake in all types of companies. All in all, the changes weren’t considerable. The companies controlled by insiders (workers cooperatives) retained the same ownership structure in only 40 percent of cases; in 23 percent of cases, strategic investors took over the company. Gradually, the companies that were not public were deciding to list their shares on the stock exchange.

25 The “fast follower” business strategy is usually contrasted to the “first mover” strategy. The fast follower quickly adopts innovation that was produced by the first mover (innovator) and profits from the improvements of organisation and production. The fast follower strategy also requires high technological competencies.
5.5 Performance and ownership structure

Concentration of ownership didn’t show any positive or beneficial effects on the performance of companies. This conclusion is important in regard to the fact that the concentration of ownership in order to increase efficiency was, officially and unofficially, the declared goal of privatisation in Croatia. Contrary to the broad expectation of economists across the transitional countries and their Western mentors (e.g. the World Bank), this result, where the concentration of ownership didn’t have a beneficial effect on companies’ performance, is consistent in all analysed transitional countries, Slovenia, the Czech Republic and Poland:

“What is surprising in our results (given what seems to be a fairly broad, albeit far from universal, agreement among economists dealing with corporate governance, theory of the firm, etc) is that the aforementioned concentration process is not accompanied by improvements in performance.” (Błaszczyk and Woodward, 2001, Introduction, p. 25)

Public companies, in Slovenia, were more successful than non-public companies that were owned by internal (employees and management) or external owners (strategic partners, privatisation funds, the state). I would like to emphasise the abovementioned finding that the change of the ownership structure (concentration of ownership) didn’t have an effect on the performance of public companies. Although public companies were selected as among the best Slovenian companies, nevertheless, I confidently conclude that the most important and, probably the only distinctive point that had a beneficial effect on the performance of public companies was the transparency and public control of their business. If public companies were more successful than non public companies, regardless of their ownership structure (internals, externals, strategic or financial investors) and, if a change of the ownership structure (presumably toward the concentration of ownership) didn’t have a beneficial effect, this implies that the transparency of business was beneficial for the performance of public companies, perhaps more than the pressure of internal or external owners and strategic or financial investors.
Chapter IX

Lessons from the Slovenian case

Although Slovenia and Croatia inherited the same property regime; and the first steps of the transformation of the property regime were in both countries to some degree similar, the description of privatisation in Slovenia and in Croatia clearly shows that the paths of transition in the two countries were different, in general and in detail. I would like to return to two key hypotheses from chapter I:

1) While privatisation in Croatia bears some important characteristics of initial appropriation, the process of ownership transformation in Slovenia represents an example of the evolution of property rights;
2) While the transformation of the property regime in Croatia fits into the neoclassical framework, the process of institutional change in Slovenia looks as if the insights of the economics of property rights were seriously taken into account.

These two hypotheses are in fact four hypotheses:

1a) Privatisation in Croatia shares common features with first appropriation (explained in chapter VII).
2a) Given that the neoclassical program of transition from socialism had been clearly articulated (as explained in chapter II, section 4.2) it wasn’t difficult to confirm that Croatian privatisation basically relied on this program.

However, in the chapters on privatisation in Croatia, I demonstrated that some expectations from the neoclassical program weren’t fulfilled; for example, intensive trade didn’t follow the initial allocation of property rights. I also showed that the concepts developed within the property rights framework were capable of explaining some phenomena, which weren’t predicted within the neoclassical program, but which emerged during the process of privatisation; for example, because the enforcement of property rights was extremely costly, a large proportion of individual shareholders abandoned their holdings.
Therefore, it now becomes necessary to provide evidence that

1b) Slovenian privatisation was an example of the evolution of property rights and;
2b) The path of institutional changes in Slovenia looks as if the insights developed within the property rights framework were taken into account.

There is nothing controversial if the transformation of the property regime in Slovenia is explained as an evolution of property rights (1b). Consequently, there is no need to argue this point beyond what I have set out in my historical narrative. This hypothesis is significant only as a contrast to the revolutionary changes in Croatia. In reality, the Slovenian hypotheses are intertwined: if the development of economic systems occurred, the economics of property rights analyses the inherited property regime, including its costs, benefits and norms of behaviour. If property rights economics was employed, then the inherited property regime would not be neglected, and privatisation should be organised as an evolutionary process. Though the existing social norms in Croatia were neglected, the relationship between the local community, the local bank, local political leaders and a local company, which was characteristic of a segmented socialistic market, reappeared in Croatia even after privatisation but not necessarily in a desirable form.

The evidence that will be presented in the following sections, that inherited social norms in Slovenia were understood as social capital and weren’t neglected, confirms both hypotheses: what happened in Slovenia fits within the economics of property rights framework, and this was an example of the evolution of a property regime. At the end of the chapter, I will comment on whether a gradual transformation of the property regime was a self-conscious choice based on the articulated insights developed within property rights literature; and to what degree it was an adaptation of changes to the given political and social circumstances.

1. Social capital

Almost all privatisation schemes, from the initial British privatisation in the 1980’s, have placed great weight on the favourable distribution of ownership rights to employees. It was very often decisive for the success of the project. The privatisation of Gorenje, one of the largest manufacturing companies in Slovenia, illustrates the importance of respecting existing social and economic
relations for the outcome of the process. Gorenje has been a producer of household appliances, refrigerators, washing machines and kitchen stoves; at the end of 2002 it was ranked eighth among producers of household appliances in Europe and it employed 6700 people (Filipovic 2004, p. 101). Gorenje was established in 1950, when a group of craftsmen from a Slovenian province decided to establish a workshop. The management of Gorenje, at the beginning of the 1990’s, emphasised its “excellent labour relations, firm loyalty of employees and strong ties with the local community” as an important legacy from the first four decades of its development.

At the time of the transformation of the property regime in Slovenia, Gorenje - as was the case for many other Slovenian companies - was in crisis due to the shrinking market in the former Yugoslavia and in East European countries. Joze Stanic, the General Manager, firstly

secured employee support for an austerity program. Given full information about the situation in which the company found itself, and the need for employee support to secure its survival, the employees agreed to significant pay concessions, which in practice, brought wages below the minimum level accepted in national union negotiations. In return, the employees received certificates guaranteeing them a certain percentage of stock after the company was privatised. Although the risk for the employees was substantial, since in the event of bankruptcy they would be left with no valid claims toward the company, they unanimously accepted the deal. (Filipovic 2004, p. 103-104)

Obviously, the employees didn’t insist on wage maximisation, contrary to theoretical expectations about workers’ cooperatives, as was shown in the chapter on self-management and social ownership. The practice of giving employees certificates as compensation for lower wages was often implemented in Slovenia; these certificates were recognised in the initial proposal of privatisation and in the final law. Annalists of privatisation in Slovenia have found that in transition countries, the workers interest in protecting their employment, using their right to manage the company, might be a viable policy in a period of crisis. (Smith et al 1997)

1 This fact fits into our hypothesis from the chapter IV about self-management; that this unique property regime was accepted owing to its similarity to traditional communal ownership.
2. An alliance for capitalism

An alliance that was created between employees and policy makers in Slovenia produced some surprising outcomes and enabled a radical restructuring in cases where it was necessary. In Slovenia “[L]arger layoffs occur[ed] in the group of companies with majority employee representation on supervisory boards than in the group with minority employee representation” (Simoneti and Bohm 2001, p. 7) A reduction of employees was easier with the support of workers in management structures. Actually, the largest layoffs occurred in the course of privatisation when employees massively availed themselves of state-sponsored schemes for early retirement. This, however, didn’t preclude their participation in the privatisation of companies, as former employees, who had the same rights to acquire shares on a privileged basis as current employees. Such early retirement schemes were later abolished, but former employees appeared to be a surprisingly stable group of shareholders. The fact that the decrease of the percentage of their ownership was unexpectedly low, confirms that they remained firmly connected with the company (Simoneti et al 2001, p. 29).

At the beginning of the process of institutional changes, bankruptcy as a form of ownership restructuring didn’t work (the market for corporate control was weak). At that time, unsuccessful companies placed themselves into the hands of the Government for restructuring. It is hard to believe, but the Government was a very assertive owner. Will Bartlett (2000) reports:

In its initial phase the Development Fund was the recipient of the shares of companies which ... were ... in financial difficulties and were at risk of bankruptcy. Altogether some ninety-eight companies were taken over by the Fund for restructuring. The restructuring process itself involved introducing new management and financial systems, and lying off redundant workers. It often also involved splitting up large conglomerate enterprises into more manageable small or medium-sized units... During 1993, thirty of the remaining companies improved their business results, twenty-one remained in the same condition and twelve operated at a loss. By May 1995 more companies had been successfully restructured and sold off, and the Fund had only fifty of the original ninety-eight companies left under its management.

I would like to remind the reader here of the thesis of the Croatian sociologist Zupanov, that was mentioned in chapter VI (footnote 21), which argues that
socialist reforms weren't successful because the alliance between the Communist Party and the working class was blocking the modernization of society and the innovative ideas of those excluded from that alliance (the intellectuals, the management class). In Slovenia, it is obvious that a reformed political elite and reformed employees, who became owners, created an alliance for capitalism.

It needs to be mentioned here that the Croatian Government launched a similar plan for the restructuring of large unprofitable companies. In the first round, fifteen very badly performing companies were excluded from privatisation and taken over by the Government for rehabilitation. Over time, more and more companies went to the Government for rescue (shipyards, heavy industry, the chemical industry, agricultural companies and so on). Finally by the end of 1999, the Croatian Government revealed that the plan had failed completely: not one of these companies went bankrupt or was restructured or recovered. The method that was efficient in Slovenia didn’t work in Croatia, in my opinion, exactly because of the exclusion of the public and employees from the decision-making process.

3. Slovenian and Croatian owners

Croatian and Slovenian approaches to privatisation were different. However, the question begging to be asked is, which one was better? It is not possible to answer this question straightforwardly. It may be that the choice of which path to take was not free; that it depended on circumstances. Further, which approach was better depended upon the goals that were to be achieved. However, the difficulty in selecting the better approach doesn’t prevent a comparison of the performances of both privatised companies and national economies. I will now provide a brief evaluation of the restructuring in Slovenia, where companies in large part were owned by insiders and where ownership was predominantly dispersed; while in Croatia, ownership was mostly concentrated. Firstly, I will provide the macroeconomic context of restructuring.

Both countries suffered a transitional crisis. Croatia’s recession was deeper and longer, certainly because of the war, though the radicalism of the changes increased the costs of transition as well.\(^2\) The inflation rate in Slovenia was lowered from the level of two percent monthly at the beginning of 1990’s to 6-7 percent yearly.

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\(^2\) There are no exact figures, only estimates are available. Druzic notes that the decrease of the Croatian GDP in 1991 was minus 21 percent, and in the next two years minus 11 percent and minus 8 percent respectively (Druzic 2005). Slovenian GDP decreased between 5 and 8 percent in the first years of transition. A GDP growth of 2.8 percent was recorded already in 1993.
at the end of the decade. The Croatian anti-inflationary program, as described in chapter VII, resulted in a deflation of 3 percent in the year 1994. Because of the shortage of savings, interest rates in Croatia reached 30 percent several times during the 1990’s. Banking loans to Slovenian companies shrank from 23 percent of the GDP in 1994, to 15 percent of the GDP two years later, and the new stock exchange recorded only modest trade. The investment activity of companies depended on the capacity to create internal funds. Finally, the growth of GDP in Croatia was, from 1994 to 2004, a little higher than in Slovenia, obviously as a consequence of the previously deeper crisis: GDP growth in Slovenia reached 4 percent on average, and was stronger in Croatia – 4,3 percent.

The Croatian economist Vehovec (2003) analysed the performance of the 500 largest Croatian privatised companies and the 1000 largest Slovenian privatised companies. Without going into a deep analysis of the relationship between the ownership structure and the improvement of performance, which is not straightforward, I will present the comparison of the restructuring in Slovenian and Croatian companies. The conclusion is that Slovenian entrepreneurs implemented radically different tactics for restructuring companies from those applied by the new owners in Croatia. Croatian decision makers were oriented to reducing the number of employees. This was considered a restructuring and the introduction of a new form of organization of production, because socialism suffered from over-employment. This was almost the only entrepreneurial skill promoted in Croatia during the 1990’s. Figures that follow confirm that Slovenian decision makers were, by contrast, oriented to the introduction of new goods/products or to the opening up of new markets.

From 1995 to 2000 Slovenian companies reduced their average number of employees minimally, from 258 to 244. At the same period Croatian companies reduced the number of employees by 22 percent (4 percent yearly). Productivity in Slovenia increased by 77 percent, and in Croatia by only 30 percent. The total

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3 Further comparison of Slovenia and Croatia is based on Vehovec (2003). The sample was of firms which, in Slovenia in the year 2000, employed 75% of all Slovenian employees and collected 85 percent of the total income. Croatian companies from the sample collected 86 percent of the total income and employed 81 percent of employees in Croatian companies.

4 Commenting on privatisation in the UK, John Kay (2002) puts it this way: “It used to puzzle me that managers in either public or private sector, told to reduce their workforce by 10%, could always do it.”

5 Croatian unemployment surged to more than 22 percent. In Slovenia, in one short period, administrative unemployment surged to 14 percent (measured by the standard of the International Labour Organisation, it was much lower) but it soon dropped to less than 10 percent for the rest of the 1990’s.
income of Croatian companies from the sample decreased by 2 percent for the respective period, while in Slovenia it increased by 7 percent every year. Slovenian wages improved, though not as much as company income, at only 22 percent for the period of six years. In Croatia, employees who retained their jobs enjoyed 18 percent higher wages, regardless of the shrinkage of the market. Though Croatia enjoyed an explosive growth of new companies\(^6\) similarly to other countries in transition, the same tendency towards rent seeking is recorded among them, as well as among older, larger privatised companies. With the increase in the number of companies, illegal activity and the grey economy thrived (Franicevic 2005; Bicanic and Ott 1997). The seeking of market protection was widespread. The State Audit Office reported (SAORP Final 2004) that more than one fifth of the privatised companies were bankrupted by the end of the 20\(^{th}\) Century.

Although the relationship between ownership structure and business performance is not straightforward, it would seem highly plausible to suggest that the different restructuring strategies in Slovenia and Croatia were a consequence of the different ownership structures. Similarly, different ownership structures were a consequence of different policies of privatisation. However, I do not have any illusion that Slovenian companies, where ownership was dispersed but dominated by insiders, represent an ideal structure for all markets and all times. When the transitional turbulences had passed, Slovenian economists found that this ownership structure, together with regulations that strongly protected employees, represented an impediment for the further development and growth of the corporate sector, since insiders frequently weren’t willing to list their companies on the stock exchange, where the transparency of business would have created a further incentive for an improvement of business performance. Indeed, the position that arrangements that work well in some circumstances will not necessarily be ideal in others, itself fits well within the economics of property rights perspective. I am concerned here only with the relationship between the policy of institutional changes (the method of privatisation), its ideological and theoretical background, ownership structure and economic development in both countries, Croatia and Slovenia.

4. Slovenia and property rights economics

Throughout the latter decades of socialism and at the beginning of the transition period, Aleksander Bajt was the most influential Slovenian economist. Strongly pro-

\(^6\) The number of companies increased from 10000 in 1990 to 65000 in 1997.
market oriented, Bajt in 1963 established the Economic Institute of the Law School in Ljubljana, the Slovenian capital, and headed it until the beginning of the 1990’s. The Institute, while having fewer than 10 employees, was among the most influential economic institutes in the former Yugoslavia and was usually called Bajt’s Institute. Bajt claims that he introduced the distinction between economic and legal property rights in the early 1950’s, as an outcome of the analysis of self-management and social ownership. At the beginning of the discussion about the paths of transition, Bajt (1992) produced a working paper entitled “A Property Rights Analysis of the Transition Problems in the East”, which was later published as a separate brochure. Hence, there is no doubt that Bajt and his approach to the transition belong to the property rights framework. Joze Mencinger, the next most influential Slovenian economist at that time, an author of the proposal for insider privatisation in Slovenia, had been a member of the same Institute, and his papers on transition frequently quote Bajt’s insights. A major two-volume selection of papers on the economics of property rights, published by Edward Elgar, includes papers of both Mencinger and Bajt. Therefore, the discussion on the transition from socialism in Slovenia evidently was under the influence of the property rights school. In other words, the insights developed by property rights economics were taken into account in Slovenia. This is precisely my above-mentioned hypothesis.

However, these biographical details are not the strongest possible argument; they are only indirect evidence concerning the nature of the Slovenian approach to the transition from socialism to capitalism. Quotations from the discussion about privatisation that rely on concepts and principles developed within the property rights school would represent stronger evidence of that influence. One such quotation I provided at the beginning of chapter I. Another one was the constant Mencinger’s warning about the importance of the “institutional and social environment” (Mencinger 1996). A third example would be the description of the development of the ownership structure of Slovenian companies (chapter VIII, section 5), which was based on research conducted by Slovenian economists (Simoneti and Böhm 2001, Simonet et al 2001). Since property rights economics investigates the relationship between ownership structure and economic efficiency, the mentioned description, thus, inherently belongs to the property rights framework.

4.1 The discussion and the reality

A lot of papers, research and investigations were delivered before and during of the process of privatisation. I have already quoted (in chapter II) Bajt’s above-
mentioned paper (Bajt 1992) that was delivered at the beginning of the process of transition, when the discussion about privatisation in Slovenia was heating up. It is interesting to discover – through the reading of this paper today, almost twenty years later – how surprisingly accurate Bajt’s warnings were on possible undesirable outcomes of the process of privatisation. For example, on page 10, Bajt implies that persons who acquire majority ownership by the way of the large scale of privatisation might lack entrepreneurial and managerial skills, and it would take a long time until resources came into skilled hands. This clearly resembles the problems of sole ownership, as described by Barzel (chapter III, section 4.1), but more importantly, Bajt predicts a destruction of resources in the meantime. A number of transitional countries, Croatia among them, experienced such a development as a consequence of an irresponsibly designed process of privatisation. However, I do not consider that predicting of the future is a particularly important theoretical achievement. Rather, I am trying to identify the relationship between theory (in this case Bajt’s warning) and reality (the Slovenian pattern), between theoretical investigation and academic discussion on the one hand and a real development on the other.

I have already mentioned that the term “the economics of property rights” doesn’t offer a fully coherent theoretical system, but rather a broad stream of related economic thoughts. As far as I know, Bajt’s distinction between legal and economic rights was not based on the concept of the costliness of property, but relies on the conclusion that legal ownership doesn’t guarantee an actual economic right to capture an income from a resource. In my opinion, this distinction is theoretically better founded and easier to conceive if the costliness of property was taken into account. Nevertheless, Bajt’s understanding of property rights, as an economic feature, and the consequences that he derives from this understanding, includes him in the mainstream of the property rights school. The analyses of some other Slovenian scholars follow major property rights ideas, although they didn’t openly declare themselves as property rights theorists, nor were their papers published in property rights collections.

Usually, all this would be enough to confirm the hypothesis that insights developed within the property rights framework were taken into account in Slovenia. However, my hypothesis was, further, that the real process of privatisation in Slovenia looks as if property rights theory was taken into account. Hence, the strongest argument concerning the influence of the property rights understanding of how capitalism emerges and works would be the evidence that its principles were incorporated into the design of the process of privatisation in Slovenia.
I will here, refer to three issues that are inherent themes of property rights economics and that were strongly present in the Slovenian discussion on the transition. It should be noted that the neoclassical program didn’t devote particular attention to those problems.

1. The importance of the inherited property regime and social norms was emphasised.
2. The economic efficiency of various ownership arrangements and the interests of various owners were discussed.
3. The building of the market was understood as a process, in contrast to the conception that proposed the sudden establishment of a market economy.

### 4.2 Labour and capital

As for point 1, this did not amount to the idea that the socialist property regime and social norms were to be preserved. The issue is that they should not have been neglected. Bajt ironically compared those pro-market reformers who blamed people as “not ready or able to behave as presumed” with the designers of economic reforms in socialist countries in the past (Bajt 1992, p. 18), who blamed the people for their failures. As for social norms, Bajt warned that a sense of solidarity and an ingrained egalitarianism might prevent the development of a competitive market in particular segments of the economy (p. 13). In regard to inherited economic property rights, he emphasised that managers were the best informed and that the design of a privatisation proposal should take this into account (p. 19). Actually, he proposed the strengthening of the property rights of actual economic owners; if not – Bajt predicted – actual owners would acquire resources informally. Indeed, this happened in the form of so-called wild privatisation (chapter VIII, section 3.5.1). Bajt also found that the previous system in Slovenia didn’t destroy resources but in fact had developed them, though its productivity and the efficiency of investment were lower than in comparable capitalistic countries. The potentiality for improvement, he basically found in the liberation of the market for “intangible property” like entrepreneurship and skilled labour. Mencinger was the one who applied Bajt’s insights, which were relatively abstract, and transformed them into concrete conclusions on how “the existing property rights, particularly those of managers, ought to be strengthened rather than weakened and destroyed”, for the purpose “[of avoiding] the adverse effects of privatisation” (Mencinger 1996 p. 418, Bajt 1992, p. 19). In general, it might be said that the development of skilled labour in the new circumstances and its necessary protection from the owners of
financial capital was an important subject of the discussion on privatisation in Slovenia. It seems to me that this subject was even overemphasised and that this imposed a barrier on the future development of the Slovenian property rights regime. It was shown in chapter VIII that favouritism towards insiders, managers and employees, later prevented the development of a possibly more efficient ownership structure in some companies.

4.3 Ownership and efficiency

As for point 2, the above description of privatisation in Slovenia and analysis of its outcomes clearly demonstrates that the investigation of various ownership structures was ever-present in Slovenia before and throughout the privatisation period. In fact, because of the uniqueness of self-management, this subject was a traditional topic among the economists of the former Yugoslavia. At the same time, this theme distinguishes clearly the economics of property rights from neoclassical economics. At the beginning of privatisation, the discussion was about insiders vs. external owners and financial vs. strategic owners. It was obvious that Bajt and Mencinger favoured insiders and strategic owners and blamed the opposing proposal of voucher privatisation for advocating external owners and financial investors (privatisation funds). Though the method of initial allocation of property rights represented a kind of compromise, nevertheless, insiders got an advantage and protection from external owners. In contrast to Croatia, banks were discouraged from taking part in privatisation, and regulation of the financial market limited the activities of privatisation funds and foreign investors. In the course of the process of institutional change, Slovenian economists advanced three conclusions in regard to the relationship between ownership and efficiency.

a) An efficient ownership structure might depend on technology, industrial relations, on the level of education of the management and employees, business culture, access by the company to additional financing, on the type of financial market and on the stage of development of the economy (Smith et al 1997, p. 173).7

b) The possibility for a company and an economy to achieve an optimal

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7 Smith; Cin, Vodopivec, ibid, page 163; I would like to recall here the conclusion advanced by Eugen Fama, that success of a particular ownership structure depends on the size of the company, the technology of production, the characteristics of assets, the characteristics of the market in which the firm has to win its competitive advantage and survive, which was quoted in chapter III, section The ownership structure of the firm.
(competitive) ownership structure depends on the initial allocation and regulation of further ownership transactions. 

c) The crucial privatisation question was about the endogeneity or exogeneity of the ownership structure: whether the ownership structure determines economic performance or is itself determined by performance and the factors that determine performance. (Błaszczyk et al 2003, p. 7)

Point c imposes an important constraint on analyses of the development of property regimes. Simply speaking, because of the problem of adverse selection it is not possibly to conclude a priori which ownership structure increases company’s efficiency. For example, if private companies were more efficient the causal relationship may not be that private owners were more efficient but it may be that more efficient companies attracted private owners who were allowed to acquire resources. If public companies (listed companies) in Slovenia were more efficient it might be that more efficient companies went public. It is not easy to conclude a priori whether efficient and successful companies developed an adequate ownership structure (attracted responsible and inventive owners) or vice versa, whether the ownership structure affected an increase of efficiency. This implies that an arrangement featuring a supposedly efficient ownership structure (whether it was insider ownership or majority owner) doesn’t necessarily increase efficiency. Therefore, it is necessary to observe carefully the empirical development of ownership structures and companies’ performance and then to derive conclusions that might affect the changes of institutional framework. In fact this was a strategy which was implemented in Slovenia.

4.4 The piecemeal development of the market

Bajt and Mencinger strongly attacked the voucher proposal as an attempt at the instant creation of a market economy. For Bajt (1992, p. 8), within this approach “it remains a mystery how ‘genuine forces of competition’ can be set up”. Mencinger criticised “uncompromising faith in a capitalist market mechanism”. Bajt openly advocated a piecemeal approach to institutional changes and proposed, as the first step, a liberation of those segments of the market that were obviously overregulated (for example, wages and management rewards). From this perspective, privatisation of state owned property was a “market result, rather than [being the] starting point, as in mass privatisation” (meaning

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8 Theoretically the importance of initial allocation and the characteristics of the market are explained in chapter III (the analysis of the Coase Theorem).
the voucher privatisation). The voucher proposal reminded Mencinger of “a
grandiose administrative operation which might be envied by central planners,
but which does not increase economic efficiency”. There is no doubt that such
thinking posed various constraints on the development of the financial market
in Slovenia, which were described in chapter VIII (section 5.2). It is not possible
to conclude *ex post* what would happen if a different regulation had been
imposed. In my opinion, the postponement of the transferability of shares gave
an opportunity to shareholders to investigate the attributes of their holdings. On
the other hand, it imposed barriers which prevented managers from enforcing
their informal property rights. The options available to financial investors
were narrowed. Whether it was for better or worse is not easy to answer. But,
it is possible to compare Slovenian experiences with the experiences that were
collected in other economies where the voucher proposal was implemented in
different way.

Mutual funds in Poland were established by the state; in the Czech Republic these
intermediaries were predominantly under the control of state-owned banks.
As Mencinger predicted, the question was raised whether companies should
remain centrally governed even after the implementation of the voucher scheme
(Błaszczyk and Woodward 2001). Because of the initial lack of demand, the
barter of stocks and concentration of ownership appeared to be a kind of natural
development of voucher privatisation: “Privatisation vouchers initially solve the
problem of limited purchasing power, but when secondary trading starts, the
problem of limited private savings re-emerges. Privatisation creates only the
supply side of the market; normal market development requires a demand side
as well.” (Simoneti 1997) In Slovenia, the restrictions on the activities of foreign
portfolio investors may be an explanation of why the lack of demand appeared.
In other countries without those restrictions (e.g. the Czech Republic) foreigners
tended to concentrate ownership. In the case of concentrated ownership, the
costs of the enforcement of property rights were lower, because the institutional
framework (formal and informal regulation) of the market for securities was not
developed enough.

The postponement of the regulation of the capital market was a common feature
in all countries where the voucher proposal was implemented. Rather, it was the
unsuccessful pursuit by regulators after the event that frequently outraged the
people. The Czech Republic was a pioneer of the voucher method, and it was often
emphasised as a model. There, “the lax legal environment and the absence of
any notification and disclosure requirements facilitated a wave of mergers and acquisitions, which… created an extensive web of relationships and [contributed to the raising of a] financial oligarchy controlling a considerable part of the economy.” (Błaszczyk and Woodward 2001, p. 12) A scandal erupted when Viktor Kozeny, the owner of the famous leading private mutual fund, Harvard Capital and Consulting - which had offered to certificate owners a 1000 percent return on investments - left the country after stripping the assets of several firms and now lives in the Bahamas (Johnson 2006). Obviously, the voucher model neglected the inherent inequality of market participants and, as a consequence, many individuals were not capable of protecting themselves. Only under severe pressure from the public, the press and the opposition parties, did the Czech Government speed up the establishment of a Securities Exchange Commission and introduce restrictions on the activities of investment funds. It is true that Slovenia, in contrast to other countries, avoided big privatisation scandals. It is hard to conclude whether the price that was paid in the form of slow development of the market of securities, was higher than benefits of social cohesion.

5. Whose benefit

Slovenian authorities frequently claimed that justice was a priority in the process of privatisation (Privatisation No 1, p. 46). Income egalitarianism was a principle of the previous regime in both Slovenia and Croatia. The Croatian model of privatisation involved side payments for those who may have felt that they were disadvantaged in the transition. This understanding of the justice of privatisation was characterised pejoratively by political analysts as clientism, but people also often felt dissatisfied. In Slovenia the justice of the process of privatisation was expressed not only in the distribution of a significant part of assets to employees and citizens; more than that a culture of transparency and the protection of those who were in an unfavourable position was emphasised. However, it is always possible to speculate that it was not a concept of justice that was at stake but that “decentralised privatisation would presumably enable control to remain in the hands of managers and thus in the hands of the old political elite. The centralised privatisation [voucher method], on the other hand, would transfer control to the government and thus to the new political elite.” (Mencinger 1996, p. 418)

In my opinion, the above analysis confirms that the process of privatisation in Slovenia looks as if the insights developed within the property rights framework were taken into account. Though he left the Government very early, before the
privatisation law was enacted, Mencinger explicitly confirmed that his and Bajt’s ideas were accepted: “One could nevertheless say that the disputes in 1991 and 1992 were worthwhile. They enabled a country-specific, step-by-step transition, which observed the legacies of the past, and prevented creation of capitalism by fiat.” (Mencinger 1996, p. 425)

6. Brief comment

In comparison to larger Central and East European countries (Hungary, Poland, the Czech Republic, Russia) the transition from socialism in Slovenia was not a popular subject of research of international experts. Maybe the fact that Slovenia is a small country is not the only reason for this. From a distance, the Slovenian transition looks easy and smooth because of its undeniable success, but a closer look reveals the exceptional complexity of the process. Moreover, after the initial allocation of assets the process remained a work in progress. Therefore, an investigation into the process of the transformation of social ownership in Slovenia might have appeared to researchers to be a great effort for a small reward. However, I don’t agree that the investigation into the complexity of the Slovenian transition is not worth the effort. The question is, was the complexity of the process worthwhile for the citizens of Slovenia? There is no definite answer to that question.

Near the end of my investigation of the role of economic theory during the transformation of the property regime in Slovenia a Swedish scholar Branka Likic Brboric (who was born and lived in former Yugoslavia before the war) informed me about the doctoral thesis of Tatjana Bajuk (1998) who investigated the same subject. However, Bajuk’s approach was different: the thesis “A Rational Transition: Economic Experts and the Construction of Post-Communist Slovenia” is an anthropological and ethnological study of the role of economy and economists during the transition. Bajuk emphasised that the mainstream of Slovenian economists opposed to the explanation that privatisation is a pure technical issue. This understanding of privatisation was advanced by an American economic expert Jeffrey Sachs. If it was to be successful privatisation must be understood and accepted by the people (Bajuk 1998, p. 126).

The previous section confirms that Slovenia was economically more successful than Croatia and more successful than other Central and Eastern European countries. It doesn’t prove that Slovenia wouldn’t have been equally successful if a different
design of the process of privatisation had been chosen. It is certain that Slovenia avoided a series of scandals that were common in the other countries. This could also be an expression of the unique Slovenian social character: there probably wouldn’t have been scandals in the case of an alternative path of privatisation. Could it be that Slovenian success was a consequence of Slovenian self-confidence? If so, the key moral from the Slovenian story might be that a forceful imposition of the pattern of transition from the outside upon Slovenia would have been inappropriate. In fact, this was the starting position of Mencinger, who claimed the impossibility of the establishment of a successful market economy by decree.
Chapter X

Conclusion

While in Slovenia the process of privatisation has been the subject of intensive scientific study\(^1\), Croatian economists recognized only in 2007 that no Croatian economic institute or similar organisation had conducted research into the process of privatisation there (Skegro 2007). The absence of research didn’t prevent several Croatian economists from concluding that the process of privatisation was as successful as in the other transitional countries (Cicin Sain and Sonje 2007). The lack of a study was possibly a precondition for such a conclusion. In my opinion, this attitude towards privatisation fits into the framework of the transformation of the property regime in Croatia. It relies on the understanding that private property is economically always more efficient than any other property regime. If privatised assets aren’t used efficiently, the market will allocate them to the place of their most efficient use.\(^2\)

The same is true in respect to the perception, which was dominant in Croatia, that privatisation had to be speedy, whatever the model chosen to be implemented. In Croatia, having no transitional experience, from theoretical controversies the wrong conclusion was derived, that there was no ideal method of privatisation; i.e. there was no confirmation that one method is better than another. However, the fact that we don’t know the ideal method (or a better method) doesn’t imply that such method doesn’t exist. Hence, even if we believe that there was no “ideal method of privatisation” and if we don’t know which method was better, this doesn’t justify the conclusion that “anything goes”. Rohatinski and Santini (1994) criticised the reasoning that “there was no ideal solution, hence the conception of ownership transformation and privatisation in Croatia was not inferior in comparison to alternatives” and what should be done was no more than to apply the Croatian conception as soon as possible (in order to escape the grip of the

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\(^1\) Intensive study of the process of privatisation is emphasised in Simoneti et al, 2001

\(^2\) Actually, it is possible to conclude only ex post that the allocation of resources at one place was less efficient than at an alternative allocation. In this understanding, any allocation of resources is the most efficient before the free market allocates the resource to a different place, only if it was a private property economy. See the section Pareto Optimality and Economic Efficiency in Sen (2005)
state). Although the thesis “anything goes” was an obvious failure, it nevertheless belongs to the consistent framework that once private ownership was established, the market would do the rest. Therefore, this must be done as soon as possible, in one way or another.

Given this understanding, any research into privatisation could only confirm the assessment that the success of the process of privatisation depends only on the percentage of privatised assets: if the percentage was high, the process was successful, no matter what happened to the privatised assets. The Slovenian approach was strikingly opposed to this. Besides there being continuing research into the process of the transformation of the property regime and its effects, the Slovenian economist Mencinger (2001) criticised the idea that “speed [should be] the main criterion to evaluate the procedures of ownership ‘restructuring’”, concluding that “[d]emands for more speed often serve only to strengthen the new political elites.”

The conclusion that a private property economy is more efficient than any other property regime might be true. In Croatia it was usually proved by way of a simple comparison of the level of development of Western countries, whose economies were allegedly based on private property and the market, and socialist countries, whose economies were organised on the basis of public (or collective) property, central planning and on the governmental distribution of resources and income. However, the conclusion about the superiority of private property and free market allocation of resources depends on the definition of private property and the market. Privatisation in Croatia promoted an ownership structure of companies that was different to that in many Western countries. The concept of private property and the understanding of a market economy in Croatia were different from in Slovenia.

This has been the subject of my research: what is property and what is private property, what is the distinction between private, collective and public property, what are property rights, and what is a market? These basic concepts determine the answers to the questions of the goal of the transition from socialism and what actually happened. The transition from socialism represents an example of the institutional change; my investigation was devoted to the causes, methods and paths of transformation of property rights regimes in Slovenia and Croatia. This research aims to be a contribution to the understanding of the development of economic cultures.
I indicated in Chapter I that the following topics would be analysed:

1. The actual processes of privatisation in Croatia and Slovenia.
2. The doctrines that stimulated and legitimised the transformations of property regimes.
3. Whether the Croatian and Slovenian doctrines fit the actual processes of privatisation in these countries?
4. Where the consistency of a particular doctrine of privatisation, for example, one which was based on neo-classical economics, is challenged by some competing understanding (one based on the economics of property rights) does the actual process of privatisation truly reflect this controversy?

Two main hypothesis were advanced:

Firstly, I concluded that the process of privatisation in Croatia fits the neoclassical understanding of how a market economy emerges and works, while the insights that were developed by the economics of property rights were taken into consideration in Slovenia. Secondly, in my understanding, the process of privatisation in Croatia looks like initial appropriation, while in Slovenia, it represents an example of the evolution of a property regime. These two hypotheses complement each other: initial appropriation fits into the neo-classical understanding of the development of a market economy; the economics of property rights investigates the evolution of property regimes.\(^3\)

**1. Plan of the chapter**

The distinctions between the Slovenian and the Croatian paths were systematised in Table 1 (in chapter I), which is placed here below, again. In the first part of this chapter, I will – following the characteristics of the two paths and the two theories that were emphasised in the table - present the main findings of the research in regard to the above two hypothesis. The role of experts who advocated the two theories will be commented on, as well as how these theories were implemented, bearing in mind the

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\(^3\) Beside these two possibilities, that the process of privatisation takes a form of initial appropriation or that it would be an evolution of property regime, Jeremy Shearmur raised the question about the understanding of privatisation in the countries of transition as the creation of a new property regime simply by governmental action. It seems as if my classification fails to recognise this third option. Indeed, privatisation laws imposed by governments formally triggered the processes of privatisation in the countries of transition. In my opinion, this initial allocation of assets by the governments is just one element of the process that might develop in different directions. I followed the processes in their totality and categorised the Slovenian approach, as if it was guided by the economics of property rights and the Croatian approach as neoclassical. After the initial governmental allocation of assets, the concentration of ownership *beside a market exchange* categorises – in my opinion - the Croatian privatisation as an initial appropriation.
normative use of the neoclassical theory and allowing for the fact that – according to the economics of property rights – a comprehensive theory of economic development doesn’t exist. In the second part of the chapter, I will comment on the question that was raised in the first chapter, about the political aspect of the process of privatisation.

2. Two paths

The distinctions between the two theories, in regards to property rights and the market are sketched in the first eight rows; the distinctions between Slovenia and Croatia are in the remaining four rows.

Table 1

<table>
<thead>
<tr>
<th></th>
<th><strong>Croatia</strong></th>
<th><strong>Slovenia</strong></th>
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<tbody>
<tr>
<td><strong>Neo-classical view of market economy</strong></td>
<td>The distinction between property and property rights</td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>Emphasis on property as a factor of production</td>
<td>The distinction between property and property rights</td>
</tr>
<tr>
<td>2.</td>
<td>Costliness of property neglected</td>
<td>Emphasis on the costliness of property rights</td>
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<tr>
<td>3.</td>
<td>Property rights reduced to legal rights</td>
<td>The distinction between economic and legal rights to property</td>
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<td>4.</td>
<td>Unified ownership</td>
<td>Decomposition (disintegration) of property rights</td>
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<tr>
<td>5.</td>
<td>Transaction costs <em>exogenous</em> to the market</td>
<td>Transaction costs <em>endogenous</em> to the market</td>
</tr>
<tr>
<td>6.</td>
<td>Neglect of market institutions</td>
<td>A market created by institutions</td>
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<tr>
<td>7.</td>
<td>The market as an auto-regulating mechanism</td>
<td>An efficient pricing mechanism has to be created</td>
</tr>
<tr>
<td>8.</td>
<td>Initial allocation of resources neutral</td>
<td>Initial allocation of resources matters</td>
</tr>
<tr>
<td>10.</td>
<td>Private ownership of a firm identified with having a dominant shareholder</td>
<td>Private property in a number of forms</td>
</tr>
<tr>
<td>11.</td>
<td>A sharp public–private distinction in regard to ownership</td>
<td>Combined individual-collective ownership</td>
</tr>
<tr>
<td><strong>12.</strong></td>
<td><strong>Privatisation took the form of an initial appropriation</strong></td>
<td><strong>Privatisation represents the evolution of a property regime</strong></td>
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Before the transition, the economics of property rights criticised the neoclassical framework for not being able to explain the variations of property regimes; how inefficient institutional structures survive and why some countries succeed while others do not, although their legal property rights regimes are similar. The transition from socialism created an opportunity to examine the principles derived from these two theories. The theoretical dilemmas related to these questions were sketched in chapters I – III. It was concluded in chapter II, which discussed the traditional idea of property, that the concept of ownership and the distinction between public and private property are ambiguous. Initial appropriation is defined as a sole action of acquisition of a resource by one agent, which imposes a duty upon others (to refrain from using “my” thing) without their prior explicit consent. Others may assess this acquisition as just, whether intuitively or relying on a particular reasoning (moral principles). I have found a striking similarity between the Lockean investigation of principles that may justify initial appropriation and the discussion about the morality of privatisation in Croatia; therefore I investigated whether Croatian privatisation represents an example of initial appropriation. The rush for resources and the tendency for the establishment of sole control of resources, which are – according to the property rights analysis – characteristics of initial appropriation, there caused a dissipation of resources.

Chapter III discussed the concept of property within the framework of property rights economics. The questions of why property rights evolve at all; and how this happens, intrigued me. Barzel concludes that the costliness of investigation into attributes of assets, which is a consequence of the variability of the attributes of assets, causes property rights to evolve constantly. However, the concept of the costliness of property rights is a synthesis of the development that was started by Coase’s introduction of transaction costs, and of the distinction between property and property rights, which enables the recognition of the concept of attributes of assets and the distinction between economic and legal property rights. In contrast to the neoclassical concept of the market, which abstracts from transaction costs, the understanding of the market that includes transaction costs, which are a consequence of the costliness of property, investigates the evolution of market institutions and the efficiency of different ownership structures (sole ownership, collective ownership, public property). It was argued that the costliness of the investigation of attributes of property and the costs of the enforcement of property cause the emergence of customs, and formal and informal norms of transaction and appropriation, that in the end, create an economic culture. Towards the end
of Chapter III, it was argued that the search for economic efficiency, technological change and changes of preferences stimulate the transformation of property regimes. I presented North’s and Libecap’s concepts of the understanding of the patterns of transformation⁴. However, North (1990 and 1993) emphasised that a comprehensive theory of the evolution of economic systems doesn’t exist.

**The inherited property regime:** Under the system of self-management and social ownership, the bundle of property rights was broken-up and re-allocated between workers, managers and the local public body (chapter IV). At the beginning, this was a motivating and efficient ownership structure, particularly in small companies, while later the costs of management and of the use of resources, the transaction costs of the financial system and an egalitarianism in the distribution of income, imposed barriers upon development. The idea of an introduction of employees’ shareholding had already been promoted, among the managers of companies, under socialism.

**Nobody’s property:** My hypothesis was that the process of privatisation in Croatia looks like an initial appropriation since the institutions of the inherited property regime of self-management and social ownership were not only rejected, but they were also neglected. This was clearly expressed in the emphasis that was placed on the idea that the former property regime wasn’t ownership at all, that property was in fact nobody’s. This is why the request for a speedy allocation of nobody’s resources was persuasive; it was considered and presented as a form of protection of resources, which – because they were nobody’s – were exposed to deterioration.

**Markets without information:** The notion that self-management and social ownership weren’t ownership at all, which expresses a misunderstanding of property rights economics, was not the only notion which implies that the process of privatisation took the form of an initial appropriation. The allocation of

⁴ Here, I would like to mention that North sees the first attempt of the investigation of the evolution of property rights in Marx’s analysis of the dynamics of the forces of production, relations of production and modes of production. Pointing to Marxists’ insights about social dynamics in regard to the transition from socialism might be illuminating, but I didn’t want to burden this research with Marx’s concepts for several reasons. Firstly, Marx’s concept of property is a traditional concept and it is questionable to what degree it captures contemporary dynamics. Though stimulating, Marx’s investigation confuses me since – in my opinion – it lacks methodological rigour. This could be understood, since it was a seminal investigation into the evolution of property regimes. And finally, Marx’s notion originally (and also in Marxists’ interpretation) is loaded by the ideological bias that might cause a misunderstanding of this research and of my intention to discover what happened in Croatia and Slovenia in the 1990’s.
resources without their prior evaluation was demanded. Two arguments were used to support that claim: firstly, since property was nobody's, there was nobody who could legitimately set the selling price; secondly, whatever the initial allocation of resources was, the market would re-allocate it to the place of its most efficient use. Due to the lack of information and transparency, which created a privileged position for particular market participants, additional characteristics that favoured an initial appropriation occurred: stock was exchanged without pricing; the only goal being the concentration of ownership. I quoted documents produced by Croatian authorities, which confirm that stocks were exchanged without pricing them and that the concentration of ownership was the recommended ownership structure.

Towards the end of chapter VII, I argued that the concentration of ownership in Croatia fulfilled the criteria to be understood as first appropriation: this was an acquisition of resources without the consent of those who were affected; moreover, those who were affected didn’t assess this acquisition as just. However, this marks a point of difference from Locke’s ideas; for Locke initial appropriation is acceptable to others, even though they were not asked to give their prior consent. The comparison of the economic performance of privatised companies in Slovenia and Croatia (chapter IX) strongly indicates that the concentration of ownership caused the dissipation of resources. The fact that Lockean criteria for a legitimate first appropriation reappeared in the discussion about privatisation fits into this picture.

The rationality of agents: Croatian privatisation and the principles that promoted it and legitimised it were consistent. It was assumed that initial allocation doesn’t matter for the achievement of efficiency. The actors were left free to explore their positions: insiders (mostly managers in Croatia), banks and people close to the ruling party, concentrated ownership. Their behaviour was rational. Firstly, they used their opportunities, and secondly the market was characterised by high transaction costs, so the enforcement of property rights (control over resources) and the capture of income from resources were cheaper if ownership was concentrated. Allocation of shares to individuals was also seen as a part of the country's welfare policy. However, if they attempted to exercise their property rights, small shareholders encountered unbridgeable high costs: costs of investigation of what they actually owned, and costs of forming alliances. Additionally, they were condemned as “remnants of socialism”. Since the use of

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5 This is clearly reminiscent of the Coase Theorem and the understanding of the market from the perspective of general equilibrium. This is why I was focused so much on this theoretical issue.
rights was so costly, two thirds of individual shareholders simply abandoned their holdings.

**Regeneration of old alliances:** Croatian economists recognised that the Slovenian approach was different: “While Slovenia favoured small shareholders, the outcome of privatisation in Croatia was the emergence of big business conglomerates, composed of heterogeneous companies with pre-modern symbiosis of ownership and management on the top.” (Sonje et al 2001) But the high costs of the investigation of the attributes of a resource that influenced the increase of costs of the management of business and of negotiation, that is high costs of transaction, had the effect that some inherited patterns of business were reactivated. It is explained in the chapter about Slovenia that after the initial allocation of shares employees, former employees and managers made alliances that resembled the system of self-management. As for Croatia the above-quoted authors continue: “Those conglomerates usually were too big for the management capacities of their owners, and their growth was supported by [their not repaying] banking loans, which triggered [a] banking crisis ... [The] political connections of the tops [heads] of conglomerates only confirm[ed] their economic irrationality.” (Sonje et al 2001) That is, privatisation brought on a banking crisis and the regeneration of the alliance between companies – the local community – the local bank and - the ruling party, which characterised socialism. For those who acquired the dominant position in the company it appeared to be too costly to investigate new business opportunities for their firms and to negotiate with management and employees; therefore they re-established the old relationships with political bodies and banks under influence of politics and continued the old pattern of the government of companies. It is interesting that in some other former socialist countries (Czech Republic, Poland) after the initial allocation and the beginning exchange of property rights, the old pattern of governmental control of business also reappeared (Pejovic 2003, 2006).

**The evolutionary approach:** Slovenian privatisation started from the inherited property regime and emphasised customs, habits and informal rights. The advantages of inherited social capital like loyalty to a company and the support that a company enjoyed in its local community were recognised. Aside from the necessity for an increase of efficiency, values like fairness and equality were promoted as principles of privatisation. It was expected that this approach would secure support for the process. The negotiation about the design of the privatisation law was long-lasting, and all social groups took part in it. It was
argued that smaller, more egalitarian societies, more easily introduce mutually advantageous norms into new regimes, because members trust one another (Ostrom 2000). The transformation of the property regime confirmed Slovenia as an example of a close-knit community. To sum up, Croatia attempted to wipe out the previous property regime and expected that a more efficient regime would emerge. Because of the high costs of accommodation to the new circumstances, the old customs and methods reappeared. The Slovenian approach was an abandonment of the old regime by improving it and reforming it. This is why I understand privatisation in Slovenia as involving the evolution of a property regime.

**Secondary privatisation:** Privatisation in both countries began with the allocation of a massive amount of shares. The next phase of secondary privatisation in Croatia and Slovenia diverges substantially. Although the same problems were encountered in both countries, they were solved in completely different ways. However, the key problem that wasn’t solved similarly was insider’s privatisation. In Croatia, this problem appeared as a stream of scandals, from the management bailout scandal at the beginning of the 1990’s, to the banking crisis from the end of the 1990’s. These kinds of problems were, in Croatia, systematically denied, while the theoretical background of the denial was a confidence that the market - in the end - allocates resources efficiently. In Slovenia, it was concluded that it takes time for the market to be developed; the possibility of the collapse of the market was predicted; it was recognised that different types of owners encounter different costs of enforcement and of the use of their property rights. Emphasis was put on the protection of individual shareholders (employees and citizens) because they were considered the weakest participants in the financial market. The activity of management, funds and banks was strongly monitored and in particular cases was restricted.

**The moral issue:** In regard to the moral aspect of privatisation, a distribution of assets to workers and citizens, in Croatia, was considered as a form of social policy. This might be understood as a side payment: it was aimed to provide support for the process. As for the further development at the financial market, Croatian economists predicted the possibility that individual shareholders would sell their holdings below the price that might be considered reasonable, but they also explicitly stated, “why would anybody care about it”: it was assumed to be the responsibility of individual shareholders (chapter V, section 5 – *The moral issue*; chapter VII, section 3.2 – *The destiny of individual shareholders*). However, I argued
that the issue of morality couldn’t be excluded from the market transaction (chapter III, section 3). Not only that “why would anybody care about it” was also a moral position. It was demonstrated that formal and informal institutions (customs, moral norms, laws, etc) facilitate and restrict the exchange of property rights (chapter III, section 3.1, *Market with costly property rights*). In Slovenia, “transparency and fairness” were emphasised as the principles of the regulation of the market for securities; it was concluded that a lack of transparency and fairness might endanger an effective corporate restructuring, which was considered a long-term goal.

I would like to emphasise again that this research is not a normative but a positive analysis of the transition in Croatia and Slovenia. I do not advocate a particular concept of universal fairness or a particular principle for the distribution of property during privatisation, but I do think that the participants assess the process not only in practical terms but also morally and decide to participate in or to undermine it.

### 3. The market and ownership structure

In Croatia, the costliness of property was overlooked; that is - the necessity that the shareowner investigates characteristics of his or her the holdings and what it would be possible to do with them was neglected. Transaction costs for individual shareholders were too high; two thirds of them abandoned their assets and many individual shareholders sold their shares for prices that might be called “unreasonable”. The prices on the Croatian market for securities (shares) adjusted to reflect the low transparency and the number of obstacles in the market (chapter VII). The distinction between legal and economic rights and the existence of transaction costs were recognised in Slovenia and were addressed by means of institutional constraints. On the one hand, these regulations enabled incumbent owners (insiders) to investigate opportunities and consolidate their ownership, but on the other they prevented the exchange of stocks and the creation of new ownership structures (the possible concentration of ownership). The outcome was different from that in Croatia.

However, I don’t claim that the ownership structures in Slovenia were, a priori, adequate, while in Croatia they were necessarily inadequate. What is possible to identify was that privatisation in Croatia was full of scandals; bankruptcies and financial crises while Slovenia avoided that type of problem. Therefore, I don’t think that the defenders of Croatian privatisation were right when they
claimed that the low support of the public for the process was simply the result of propaganda by the political opposition through the media (Skegro 2007).

**Owners, performance and the market:** The question of how to achieve a competitive ownership structure is the most intriguing problem concerning the process of privatisation. Actually, it was the goal of the transformation of the property regime. The relationship between the ownership structure and the performance of companies initiates the crucial privatisation question (about the endogeneity or exogeneity of ownership structure): whether ownership structure determines economic performance or if it is itself determined by economic performance and the factors that determine economic performance. Ownership structure relates to several factors:

- It depends on the initial allocation of property rights. (Cf. the analysis of the Coase theorem in Chapter III.)
- It depends on the characteristics of the market in which the firm has to compete for its survival. (Cf. chapter III, the section on *Individual and collective ownership.*)
- It depends on the characteristics of the market in property rights. In order to prevent a dissipation of resources, the transferability of ownership over the flow of income (where shares represent the right to a percentage of income) is usually controlled by formal and informal institutions; while in the case of ownership over stock the market might be less constrained. (Cf. chapter II, *Privatisation and initial appropriation.*)

I have argued that, in Croatia, the ideas were promoted: that (1) there should be a dominant shareholder and (2) the financial market should be loosely regulated (the market was characterised as free and non-transparent), while in Slovenia, the regulatory framework favoured both the dispersed shareholding of public companies and insiders’ ownership. It might always be said that (a) the emergence of dominant shareholders in Croatia and their relative absence in Slovenia was a consequence of the characteristics of the market; (b) the creation of market norms in Croatia (and less in Slovenia) was left to market participants and; (c) market participants in Croatia didn’t agree about the necessity to increase the transparency of the market.

If a non-transparent “market” decides the ownership structure, then there is no guarantee that a competitive ownership structure will be selected: from one side,
the regulation of the market affects the ownership structure and, from the other side, the ownership structure affects the regulation of the market. Therefore, if concentrated ownership is the prevailing ownership structure, it is highly probable that dominant shareholders tend to retain low transparency of the market. An increase of transparency and competitiveness of the market may endanger the position that they acquired and the relationship with the government that they had established. It takes time and number of trials and errors to develop a transparent market for securities in a world of dominant shareholders, whose activities are financed by insider relationships with banks.

**Concentration of ownership and the market:** If the goal of privatisation is the creation of private property, some theorists - who questioned whether dispersed shareholding represented private ownership at all - would have supported the inclination of Croatian authorities toward majority ownership. It enables the effective control of a resource, the cheaper enforcement of property rights and – under conditions of an absence of formal and informal institutions that facilitate transactions – it lowers costs of transacting, since a majority owner offers particular assurance that transactions will be completed properly. A majority shareholder might be understood as a long-term financial investor. Barzel emphasises that a financial investor guarantees stability of wages. The usual weakness of majority shareholding is the same as the disadvantages of sole ownership: a lack of specialisation of a dominant shareholder who at the same time governs the company. The Croatian economists quoted above identified the deficient capability of majority owners to manage successfully the conglomerates under their control. If they employed a professional manager, the principal-agent problem appears. However, if the majority owner was incapable, then a different investor might take over his company. An efficient, speedy and smooth takeover requires a bank loan or the cooperation of many financial investors. In other words, for the purpose of improving the use of a resource, it is important to split up a unified ownership and expose the components to market exchange. Instead of guarantees that were provided by the majority owner, the exchange of components of ownership rights requires a different kind of guarantees. Stability and viability are to be confirmed by the transparency of business activity and its performance; market participants build their reputation and introduce formal and informal

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6 To name just few: Armen Alchian and Harold Demsetz, Stephen Munzer, and even Karl Marx

7 It is ironic that in Croatia, individual owners of companies during the second half of the 1990’s, at a time of the banking crisis, often failed to provide salaries for their employees and pulled out assets from the companies at the expense of workers.
norms of behaviour. This is why a market for securities is often constrained by institutions. Besides placing small and large shareholders in an unequal position, the Croatian market for securities didn’t guarantee the efficiency of transactions and – consequently - it collapsed.

4. The role of experts

My main interest was to identify the theoretical backgrounds of the processes of privatisation in Croatia and Slovenia. In my opinion, the description of institutional changes confirms that privatisation in Croatia really followed a neoclassical scenario, while the Slovenian privatisation fits into the pattern described by property rights economics. If this was the case, the question is whether unknown objective circumstances caused Slovenia and Croatia to take different paths, or whether this was a choice made by their decision-makers and experts which was influenced by theoretical considerations. I have provided evidence that Croatian experts and authorities promoted the neoclassical scenario, while Slovenians took into account the insights that belong to the property rights school. Nevertheless, there was the possibility that particular objective constraints forced the decision makers in Croatia to choose the neoclassical approach, while a different situation was the reason why Slovenians decided differently. What could these constraints be: political circumstances, the inherited property regime (which was the same), the characteristics of industry that was to be transformed, social norms and customs?

There is no doubt that all of these were important. Slovenian experts emphasised some of these circumstances (for example social capital) while this type of discussion in Croatia was basically lacking. In my opinion, from the above discussion about an interdependence between ownership structure and the characteristics of the market - where owners shape a market and market constraints affect that a particular type of owners dominate – follows how important the role of experts for institutional change may be. While “objective circumstances” influence one other (political structure affects the nature of the economy and vice versa) the experts may create expectations about how things could be different and may break a closed circle. This is why I think that in the Slovenian and Croatian cases the role of experts was crucial.

In chapter I, it was explained that in the discussion about institutional changes, pressure groups may promote their particular interests as the interest of all, while it
was expected that experts should promote doctrines which advocate the benefit of the general public. It is fair to analyse the doctrines that were promoted by Croatian and Slovenian experts as if they tended to promote the interest of the entire society. A problem would arise if neglected consequences or unintended effects emerge, if a theory creates privileges, produces winners and losers or favours particular social groups. It is hardly possible that the Croatian experts intended the dissipation of resources, the collapse of the market for securities, bankruptcies and asset stripping. As for the development in Slovenia, it seems that the regulation of the market that favoured insiders (employees and former employees), imposed barriers on the development of different ownership structures.

The economics of property rights finds that a dominant owner is expected where efficiency of labour is observable and financial capital investments are critical, while ‘employee owned’ ‘cooperative’ firms (partnerships, producers’ cooperatives) are expected where agents’ behaviour is very costly to monitor and human capital investments are critical. It implies that the consequence of privatisation in Croatia was the development of industry requiring low skilled labour, while in Slovenia, privatisation stimulated industries that were based on skilled labour input. However, it seems reasonable that a higher level of education and technology of production required that privatisation create adequate ownership structures that employ highly skilled labour. This fits the self-conscious conclusion of Joze Mencinger, which was quoted towards the end of the chapter IX, that the Slovenian type of privatisation favoured old political forces, meaning employees and management, while the method of speedy privatisation “would transfer control to the government and thus to the new political elite.” (1996, p. 418) However, the new elite supported financial investors.

4.1 The government and experts

Now I would like to explain my several times mentioned statement that the criticism of the neoclassical scenario doesn’t imply a plea for governmental regulation. In order to better understand this claim it should be repeated that the intention of this research wasn’t to provide a normative framework for the creation of private property and an efficient market but it aimed to be a positive analysis of the developments in Croatia and Slovenia.

One may interpret the situation as being that Croatian economists wished to privatize, and they thought that institutional issues would take care of themselves
without governmental intervention. They thought that if they gave people shares, then institutions would spring up which would allow for the trading of securities; it was as if they assumed that people would behave as they did in mature market economies, where there were all kinds of formal and informal regulations and good expectations about how people should behave. On the other side it might be interpreted (wrongly) that in Slovenia the government provided a regulatory framework and privatisation there went much more smoothly. If this was the case the question is why this should not open the possibility that the government should create market institutions.

This understanding assumes that the government or its experts knew a priori which institutions were to be imposed to achieve a fair and efficient allocation of resources. This was not an option in Slovenia. Economic experts there argued that market participants develop market institutions: if a market transaction is to happen people need to believe that everybody else will accept and keep to the relevant norms and principles of behaviour. The role of government is to legalize what was accepted by market participants and to “enhance [their] economic rights” (Barzel, 1989, p.2)

Contrary to the above interpretation of Croatian scenario, Mencinger (1996, p.425), a Slovenian economist claimed that the neoclassical program imposes capitalism by fiat. The neoclassical program – according to Mencinger – included that the duty of the government in the transition countries was at least an initiation of the growth of market economy.

The basis of my criticism of the neoclassical scenario of transition was that the neoclassical paradigm neglects the issue of institutions. The consequences of this understanding - that institutions are not important - should be understood and explained. From the unimportance of institutions one may conclude that in young and mature economies people would behave in a similar way. Actually, a key characteristic of the neoclassical scenario was that the same approach was proposed to completely different cultures and economies.

However, from the neglect of institutions, or from the thesis of their unimportance it doesn’t necessarily follow that institutional issues will take care of themselves without governmental intervention. And from the unimportance of institutions it doesn’t follow at all that - after an initial allocation of shares – institutions will spring up which would allow for the trading of securities. The question of
how institutions emerge (spring up) and develop is completely different issue and it cannot follow from the neglect of institutions (by the neoclassical paradigm and by the Croatian economists and authorities) or from their (supposed) unimportance.\(^8\) This leads to the question why a particular culture uses one institutional set, and another culture an alternative institutional set, how these two cultures interact, and how institutions evolve. I explained in chapter I that the economics of property rights doesn’t have a definite answer to the problem of the development of institutions and market economy and nor have I.

Because the neoclassical paradigm neglects institutions, Croatian economists, following the neoclassical scenario of the transition didn’t recognise that the exchange of goods and services was always regulated, formally or informally, by market participants. I explained in chapter III that in every transaction institutions always exist; moreover – that institutions enable (or hinder) transactions. My criticism of this scenario didn’t imply that market transactions should have been regulated by the government, but that they were already regulated by participants.

This is why the criticism of the neglect of institutions in the neoclassical view doesn’t imply that the government should regulate transactions\(^9\). However, the government may impose a regulation which is against the will of market participants or - in rare cases - may improve the efficiency of an allocation of resources by changing existing formal or informal regulations, but this is beyond my concern in the present thesis. From the criticism that the neoclassical scenario didn’t recognise that market transactions always include formal or informal regulation, and that the program based on neoclassical understanding considered institutions unimportant, it doesn’t follow that institutions should be imposed by the government.

Slovenian economists proposed that market participants should slowly develop a market economy, having enough time for accommodation to changes\(^{10}\). Because the neoclassical view neglects institutions Croatian economists didn’t recognize

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\(^8\) However, one may conclude that the claim that institutions simply spring up is not an explanation of how institutions emerge: they somehow spring up. However, this conclusion fits to the neglect of institutions.

\(^9\) Neoclassical economists tend to claim that they are the only critics of governmental interventionism; but from the criticism of the neoclassical paradigm doesn’t follow an advocacy of governmental interventions.

\(^{10}\) I have already commented that a reliance on the inherited ownership structure and particularly on employees to some degree imposed barriers for further development similarly to the initial allocation of resources in the neoclassical scenario.
that if they give people shares people will not behave as if institutions don’t exist; as if institutions are unimportant, people will not behave similarly to people in a mature market economy. People will rely on inherited patterns of behavior, on inherited institutions.

I will now briefly describe further institutional development in Croatia after the 1990s and then I will conclude the discussion with an analysis of the political aspect of the transition.

5. The third phase of privatisation in Croatia

At the end of the 1990’s a so-called stakeholders’ movement was observed in Croatia. The press had been reporting on tens of so called “employees head-quarters” formed to prevent outsiders’ privatisations or to prevent the bankruptcy of outsiders’ or state controlled firms. Workers were organised to save ‘their’ firms and their jobs (or at least their compensation) in numerous firms, which were seriously threatened with bankruptcy. In some cases workers occupied companies’ buildings and factories. Small individual shareholders, helped by unions, organised many firm-level associations, trying to build umbrella organisations. In the case of the largest company in the food processing industry, Podravka, and in a number of other cases, local political bodies supported workers and unions against the majority owner and the government (Franicevic and Sisek 2000).

After the death of Croatia’s President, Franjo Tudjman, a new government was elected, consisting of six coalition parties, ready to end the era of the 1990s. In that period, an exhaustive revision of the privatisation of the 1990s was conducted, but privatisation had intensified, because a lowering of political risk encouraged foreign investors. They also preferred majority ownership, especially in the telecommunications and banking industries. Nor did foreign investors restrain themselves from close cooperation with the Government and local authorities. They also obtained privileges and concessions to use particular resources, while committing themselves to take care of the community and to exercise social responsibility. If they did not, the Croatian public would condemn the behaviour of foreign investors as a new form of colonialism.

It was not easy to overcome the centralised structure of the Croatian economy. An increase in the amount of trade on the stock market was initiated artificially by several successive reforms. The work of regulatory agencies was activated. Bigger
companies were forced to list their shares.\textsuperscript{11} The Government also listed its bonds. For some time, trade was not intensified, but at least transparency increased. The Government also artificially increased the liquidity of the stock exchange by implementing pension reforms. Employees were forced to invest a percentage of their wages in retirement funds, which were invested on the stock exchange. After the general election in 2003, the new centre-right government conducted a standard listing of the telecommunications monopoly and of the oil monopoly, giving citizens the opportunity to subscribe at a significant discount.

6. The political aspect

I have already claimed that a comprehensive study of the relationship between political and economic transition in Slovenia and Croatia would be another research project, another thesis. Although the focus of this research was on the interdependence of the real processes of institutional changes and their supportive theoretical frameworks, I will conclude with a brief account of the political aspect of the transformation of the property regime. The mutual influence of political and economic reforms in the countries of transition was widely analysed, and the dominant paradigm was that privatisation, which is a key component of market-oriented reforms, initiates political pluralism, while the development of democracy supports pro-market reforms. It was explained in chapter I, that a number of hypotheses of this kind appeared to be simply wrong. Before I proceed to the description of the relationship between political and economic reforms in Slovenia and Croatia, I would like to provide an illustration of the distinctions between the political cultures in the two countries.

\textbf{National homogeneity:} It is mentioned in chapter VIII that Slovenians considered important the fact that their country was ethnically homogenous in comparison to other countries that emerged after dissolution of Yugoslavia (Prasnikar et al 2004). That is, even if nationalism in Slovenia might have been in different circumstances transformed into xenophobia, it is a fact that Slovenia avoided this

\textsuperscript{11} Thanks to the Central Depository Agency (register of shares and owners), which is a settlement agency, we can reconstruct, at least partially, the destiny of individual shareholders. While at the beginning of the 1990’s owners of shares were 600,000 people, at the end of decade only 30,000 had personal accounts registered in the Agency, but we do not know how many companies have provided their registers. Individual shareholders in companies that didn’t transfer their registers to the Agency didn’t have the same opportunities for trade as those 30000 people. In the year 2003, the figure increased to 300,000, probably owing to the pension reform. In 2008, almost 800,000 persons have shareholders’ accounts, while perhaps only one in eight were active investors and traders.
kind of sentiment and the conflicts that it initiates. I think that this fact should be mentioned; nevertheless it doesn’t excuse the leaders in other former federal units of Yugoslavia for their damaging policies concerning ethnic relationships. The transition from socialism in Slovenia is an example of institutional changes in a small close-knit community, which are usually less conflicting, while in Croatia, the war was a common excuse for serious misdemeanour and omission, though the majority of malpractice in privatisation happened years after the war, in the second half of the 1990’s.

**The rule of law**: Critics of Croatian privatisation have focused on the inefficiency of the judicial protection of property rights. Although I agree with their criticism, I do not think that all the problems can be reduced to judicial inefficiency. Even if the judicial system had been more efficient, significant differences between shareholders would have remained. A strong government retained the power to act arbitrarily if things went “wrong”. Actually, people expected the government to intervene in critical moments, and the government often gained support for its arbitrary activity. This is why, in Croatia, public disapproval of legislation that enabled the government to interfere into the private sphere was absent.

**Respect for institutions**: I described in chapter VII, how difficult the battle for the independence of the Central Bank was in Croatia, how important it was for the development of the financial market and how that battle influenced the outcome of privatisation. In Croatia, from 1991 to 2001, none of the Governors of the Central Bank kept office for the entire period of their mandate (Vujcic and Lan 2002). In Slovenia, the issue of the independence of the Central Bank was resolved from the beginning of the 1990’s; from the establishment of monetary independence, all governors enjoyed professional independence and served their full term. In many countries of former communism, the old institutions usually lost their power while still being formally active, especially if the old cadre ran them. The old unions in Croatia, while still in existence, didn’t enjoy respect in the discussion about privatisation; they were disqualified as remnants of the old system. In Slovenia, things worked quite differently: there, official responsibilities were strongly respected. Therefore, the opinion on privatisation issued by the Social Advocate for Self-Management, while that obsolete office had not yet been dismantled, was respected by the Government and the Parliament, as were the opinions of the Unions (Likic Brboric 2003, p. 213). In Croatia, that kind of discussion was routinely rejected as the propaganda of old communists.
6.1 Political and economic reforms

Finally, I would like to analyse the relationship between political and economic reforms in Croatia and Slovenia at a more general level. “Transitology” distinguishes two hypotheses: the first one (Przeworski 1991) implicates the short-term losers as the major opposition to economic (and political) reforms; and the second one, Hellman’s (1998) model of a partial reform equilibrium sees halfway winners as an obstacle to further reforms. Both models calculate with the government’s responsibility to the median voter. The first model supposes: “Governments that are NOT responsive to the median voter initiate and sustain comprehensive reforms... Responsive governments are associated with [a] low level of reforms.” (Slantchev 2005, my emphasis). In this scenario, a stable government (meaning, a government that withstands the pressure for re-distribution) initiates and sustains reforms. Transient administrations are associated with a low level of reforms. According to the first model (which sees losers as the main obstacle) the benefits of reforms are dispersed, and the costs are concentrated on the large group.

Among the losers are the newly unemployed persons, but here there are also people who have lost social security (employees) and other kinds of welfare state benefits. They are counted as an opposition to pro-market reforms. According to the second model, costs are dispersed and benefits concentrated; therefore, halfway winners oppose further reforms. Among the halfway winners are new owners, managers; while even transition theory finds that on the winning side, there are also commercial bankers, government officials and organized criminals. The first model supports a technocratic approach to pro-market reforms. The second model concludes that a stable government is a consequence of the entrenchment of the interests of winners and the solidification of their influence. “Transient administrations initiate and sustain comprehensive and successful programs ... Stable governments are associated with low levels of reforms.” (Slantchev 2005)

I would like to remind the reader here that in Slovenia, reformed communists initiated institutional changes, while in Croatia, the reforms were undertaken by the new right-oriented government. Given that during the first ten years of the transition, the same party and the same president ruled over Croatia, it was categorised among those countries with a stable government, which was able to keep on with reforms according to the first model. In Slovenia, on the contrary,
throughout this time different coalitions were in power, while from 1993 – 2000, it was only possible to form a minority government.

The results from the statistical analysis of 25 former communist countries are “strong, internally consistent, and startling”: 1) losers in the transition don’t threaten the reforms; 2) democracies do better than non-democracies; 3) the stability of democratic government doesn’t have an impact on its reform endeavours, which means that an unstable government can push reforms as well as a stable government. As for authoritarian governments, they do slightly better if they are stable (Slantchev 2005). Hence, there is no concern that reform losers will block the process of reforms; it is better to expose a government to the pressure of voters and to minimise the influence of the halfway winners. All in all, the research endorses the second model.

It seems that the development of institutional changes in Croatia and Slovenia fits with these results with a slight adjustment. A strong government in Croatia initially allocated control over resources to its clients, war veterans, former political prisoners, the Diaspora, members of the ruling parity, bankers and new majority owners; and created among them halfway winners, who opposed further pro-market reforms. Therefore, Croatian economists who advocated the rapid distribution of ownership, expecting that private property would initiate democratic reforms, were wrong. On the other hand, because the Slovenian government wasn’t stable, it was exposed to the scrutiny of the general public, which prevented the formation of an informal alliance of a political and business oligarchy.

Slovenian legislation favoured employees who were among the potential losers from transition, and protected small investors from predators. The Slovenian experience confirms the conclusion of the research, that most beneficial, for the consistent reform of the socialist economic and political framework, was the prevention of halfway winners from taking everything. The above-mentioned increase of active market participants in Croatia, after a necessary transformation of the institutional framework, confirms that citizens, employees and small individual investors were not against capitalism and the market, as long as they considered the game as fair.
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