COMMENTS ON

"Restitution vs. Indemnification: Their Effects on the Pace of Privatization" by Luis Locay and Cigdem Ural

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The problem the authors choose to solve is the seeming paradox that economists recommend some form of indemnification and oppose restitution but practitioners in transition settings have usually chosen restitution rather than indemnification. In laying out the problem, the authors set up a bit of a straw man by arguing that there are only two reasons for divergence between practice and prescription: non-efficiency issues, about which they claim economists have nothing to say, and efficiency issues, which are the basis for their argument. The latter centers on arguing that restitution can enhance efficiency by speeding the privatization process.

Before looking at the authors' argument in detail, it must be emphasized that they are already ignoring a very simple answer to their paradox. All indemnification schemes require establishing the value of the asset . Indeed, in an earlier analysis of this issue at ASCE's first meeting ("The New Institutional Economics and the Study of the Cuban Economy"), I wrote: "The key issue in this approach (indemnification) is, of course, to establish the value of the asset" (p.22) and proceeded to discuss the difficulties associated with various alternatives. If one cannot solve this problem in practice as opposed to in theory, no indemnification scheme is viable; hence, there is no paradox to be explained.

My argument above questions the validity of their motivation for the paper. Nonetheless, it says nothing about the merits of their specific argument on how restitution speeds up privatization. The authors present an ingenious model of interacting players (workers/consumers) and managers, and show how the equilibrium outcome of each pursuing their rent seeking activities optimally is one where an increase in the fraction of firms that are privately owned prior to the transition leads to a faster privatization. They assume that this corresponds to a situation with indemnification without explicitly addressing the issue of asset valuation in practice. Implicitly, it assumes that indemnification is merely a transfer of the potential profits of the enterprise from the old managers to the worker/ consumers at the time of privatization. Hence, managers want to delay and workers want to speed up privatization.

In this setting the authors introduce restitution. We now have three players instead of two but the basic outcome is the same as in the previous model. The authors discuss potential enhancements of their model and alternative explanations but again do not address the practical issue of valuation directly.

Their concluding suggestion is quite interesting but perhaps not for the reason they think. They argue that under indemnification their analysis suggests that indemnified owners should not be allowed to settle their claims until their property is privatized. Their rationale is that this gives the previous owners an incentive to speed up the process. They argue that for this to work the amount of indemnification would have to correspond to the selling price of the property. Voila, they have found one possible way of solving the asset valuation problem in practice. Of course, safeguards would be needed to prevent artificial manipulation of the prices of the privatized property. Exploring the benefits of this alternative could very well be the most valuable contribution of the paper.