Privatization in the Transition to a Market Economy

Renzo Daviddi

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European University Institute, Florence
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Abstract

The paper presents a comparative review of the privatization processes under way in Central and Eastern European countries. In line with the findings of recent economic literature, it is argued that also in economies in transition the privatization process depends crucially on the prevailing institutional arrangements. In particular, the increase in economic efficiency generally attributed to privatization very much hinges on the competitiveness and the degree of regulation that characterizes the economic system. In the case of formerly planned economies, privatization must be paralleled by the creation of an appropriate system of corporate governance. The paper reviews various privatization methods and their application to Central and Eastern European countries. Targets, constraints and implications are identified for the strategies followed by various post-communist countries. The paper concludes that despite the indisputable need to expand the activity of the private sector substantially, approaches to privatization more tailored to the institutional reality of the countries in transition would have implied lower costs for the state budget and, arguably, for the economy as a whole.

JEL Classification no. L10, L33, P31, P52.

1 I am grateful to Alberto Chilosi, Enrico Colombatto and Milica Uvalic, as well as an anonymous referee, for comments on a preliminary version of this paper. Remaining errors are my own.
1. Introduction

The debate on privatization has been going on for more than a decade. It started at the beginning of the eighties with the privatization plans of the Conservative governments in Britain and re-privatizations of the centre-right government in France. It then turned into a more general analysis of the role of the state in the economy in many developed and less developed countries.

In a wider interpretation, which concerns the definition of property rights and the transition from an economy dominated by collective ownership to one where private property prevails, it is also one of the main issues of the transition to a market economy now under way in the countries of Central and Eastern Europe (CEECs) and in the former Soviet republics.

In all these countries, which are the focus of this paper, the process of privatization has not only been perceived as an essential component of the creation of the market system, but, according to a prevailing view, the simple elimination of central planning and the introduction of private ownership would have automatically and rapidly generated the market system itself and led to rapid growth of income and wealth in CEECs.2

The transfer of ownership rights from the state to individual citizens in post-communist societies has received strong political priority and the unconditional support of the new leadership. The introduction of privatization has been an enormous break with the past and an essential component of the 'regime change'. However, the advantages of a rapid and thorough ownership transfer have been overestimated. Privatization has been seen as having only positive effects, a sort of panacea capable of immediately solving all the problems created by the transition to a market

2 For a thorough discussion of this aspect of the debate on transition, see Kregel, 1992.
economy. In a view shared by many East European policy-makers and by their Western advisors, the transfer of property rights should have taken place, mostly by transferring economic activities to the private sector, within a few months after the beginning of the adjustment process; all viable enterprise should have been privatized as quickly as possible, and all non-viable enterprises closed.

Very rapid privatization was deemed necessary in order to prevent expropriation of the existing assets by the nomenklatura and managers, to break the political control over the enterprises and to obtain consensus for the reforms. With the benefit of hindsight, all this emphasis on speed cannot be entirely justified. The market mechanism that is supposed to be established in the transition is by definition a system of evolutionary, marginal changes, and cannot handle global transformations (Frydman and Rapaczynski, 1994). It should be more correctly seen as a social institution, a complex network of signalling devices, regulations, interpersonal relations and expectations, which, in Western countries, has developed over centuries of capitalism and cannot be replicated overnight. Even assuming that in the distorted world of centrally planned economies on the eve of the transition, it would have been possible to draw a distinction between unviable enterprises and enterprises in temporary difficulty; many of the benefits that are generally associated with privatization in transitional economies (increase in efficiency, consolidation of democracy, raising revenue for the state budget, etc.) do not seem to derive any particular advantage from the rapid implementation of privatization plans. Quite the contrary, the lack of some key institutions has constrained the process dramatically. In reality, privatization (particularly of large state-owned enterprises) has proceeded much more slowly than envisaged and, in some countries, private activity has grown more as a result of the birth of new firms rather than of the privatization of existing state assets.
The experience of developed market economies (and to a lesser extent of some developing countries) has often been recalled as a useful model for economies in transition. There are indeed lessons to be learned; however, there are also enormous differences that should be kept in mind. First, there is a difference in aims. Western privatizations have mostly been devoted to reducing the presence of the public sector, as producer, in the economy. The main objective of privatization for post-communist economies has been the creation of a market environment, moving away from the previous hyper-centralized command system. It follows that the scale of the exercise is completely different. As indicated by Fisher (1991, p. 4), the largest privatization programme in a market environment, post-Allende Chile, concerned firms producing about 25% of GNP. The share of the public sector in value added in Western European countries on the eve of the privatization programmes ranged from 16.5% (France) to 10.7% (the UK and FRG). Vice versa, the share of the state sector in value added in the mid-1980s varied in socialist countries from 65.2% in China to over 96% in the USSR, Czechoslovakia and the GDR. Moreover, while, in principle, privatization in Western countries does not require an *ad hoc* legal framework, economies in transition face the necessity to adopt an extensive body of legislation and to create a number of institutions which simply were not necessary in a command system. Western market economies are characterized by the existence of markets for corporate control, financial markets and stock exchanges. Those institutions, which have evolved over decades, take a variety of forms in different countries and perform a large number of functions, especially with respect to the transfer of ownership and control of the performance of managers and firms.³ It is by now painfully clear that shortcuts do not work. Even in Central and Eastern

³ One could consider, for instance, the functions performed by the stock market: risk sharing, guiding investment, measurement of the value of assets, increase in the value of assets (Tirole, 1992, 227-228).
Europe the need exists to create an appropriate structure of corporate organization, a complex set of rules and institutions (including corporate law and appropriate banking and financial systems) which all combine to define the nature of a market economy. This process will probably take a long time; a period certainly longer than was envisaged at the outset of the transition.

The above considerations should not be interpreted as implying that before starting their privatization drive, Central and East European countries should have waited for the completion of a proper institutional framework. However, strategies could have been tailored more to reflect the institutional settings of the countries involved. In particular, the debate seems to have centred mostly on the speed of the privatization process, leaving aside other important aspects, such as to what extent should the state divestiture have been pushed or how to deal with the state sector during the transition, or how to ensure its coexistence alongside the private sector during the transition.

The remaining part of the paper will discuss some of these issues further and will review the privatization experiences of Central and Eastern European countries to date. The theoretical rationale for privatization in economies in transition is identified in the next section, starting with a discussion of the concepts of property rights and privatization. Various privatization methods are then reviewed in section 3 and their application to Central and Eastern European countries addressed in section 4. Targets, constraints and implications are identified for the strategies followed by various post-communist countries in section 5, where a preliminary assessment is attempted. The paper ends with some concluding remarks.
2. Theoretical Underpinning of Privatization

2.1. Property rights and privatization

Property rights theory (see Furubotn and Pejovich, 1974) contends that the market, as a coordinating device of decentralized decisions, must be based on an extensive system of property rights. In an economy where collective ownership prevails, the state cannot control in a proper way managerial behaviour. This is prevented by distance (in an informational sense), lack of coordination and incentives. In a society with diffused technology, for the decentralized coordination of productive specialization to work according to comparative advantages, people must have secure, alienable property rights to negotiate at low cost reliable contractual transactions as regards productive resources and products tradable at mutually agreeable prices.4

At the beginning of the transition in all formerly planned economy (economies/?) not only were property rights ill-defined, but also a normative and institutional framework was lacking, which in a market economy is capable of securing alienable property rights.5 The different nature and extension of the pre-transition reform of the state enterprise sector left the CEECs with different forms of state enterprises and

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4 According to a standard definition, the right of ownership in an asset consists of three elements: (a) the right to use the asset (usus), (b) the right to appropriate returns from the asset (usus fructus), (c) the right to change the asset's form and/or substance (abuses) (Furubotn and Pejovich 1974, p. 4). Its force is measured by probability and costs of enforcement which depend on the government, informal social actions and prevailing ethical and moral norms (Alchian, 1987, p. 1031). The rights to use (and to dispose of) goods, services or things with regard to production and exchange are designated as control rights. Such control rights may arise either as a result of ownership, or they may be delegated to the holder by others, or they may adhere to an office that the holder occupies.

5 However, even in a socialist society where supposedly private property of the means of production does not exists or is very limited, individuals in particular positions may exert a power similar to those of capitalist owners (nomenklatura). The recent experience of Central and Eastern Europe suggests in this respect a sort of continuum in the two systems. The so-called 'wild-privatization' phenomenon that has characterized the first phase of the privatization drive in all former communist countries, has not been reversed in the course of the process and the best assets of some enterprises have been appropriated by a very limited number of managers and workers of the same enterprise.
managerial control. Although the state was nominally the owner of the enterprise, in reality managers and workers were able de jure in some countries, de facto in others, to claim effective ownership rights.6

With respect to the experience of post-communist economies, the usual definition of the term 'privatization', i.e. the transfer of economic activity to the private sector (Jenkinson, 1992), is too restrictive.7 According to Frydman and Rapaczynski (1994, p. 200), in Central and Eastern Europe, 'privatization to a large extent is not so much a process by which assets in the state sector become revitalised, but rather a more or less managed process of decline and retirement of an ex-ante unknown, but largely substantial portion of these assets'.

But why (and to what extent) should the state 'wither away' in post-communist countries? For a market economy, the theoretical roots of privatization are often identified in the relationship between ownership and performance of an enterprise. The economic literature has repeatedly attempted to verify if and to what extent different forms of ownership can exert an influence on performance and behaviour of the firm. Conclusions are not unique. Some authors (see, for instance, Furubotn and Pejovich, 1974, pp. 6-8) claim that a change in ownership may lead to a different incentives structure for economic agents and induce a change in the behaviour of managers and enterprise performance. It is generally maintained that public enterprises have a lower efficiency because enterprise objectives deviate from maximization of profits and because monitoring arrangements are inadequate due to the absence of capital market discipline. However, this argument has not gone unchallenged. In fact, part of the

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6 For an analysis of the pre-transition enterprise system and of the extent to which this has constrained the choice of methods, attitudes and results of privatization, see Frydman et al., 1993.
7 As other definitions commonly accepted and based on transfer of control (Hemming and Mansoor, 1988), or the transfer of the right to receive the enterprise profit (Yarrow, 1986).
economic literature considers that a correct definition of property rights is a necessary, but not sufficient condition for increasing social welfare. For instance, Estrin (1994, p.14) reminds us that the so-called first fundamental theorem of welfare\(^8\) is indifferent to ownership rights: any given distribution of endowments or ownership rights can be supported by a competitive equilibrium.\(^9\)

The economic literature on transition (see, for instance, Grosfeld 1990, Dhanji and Milanovic 1992, Tirole 1992) identifies the positive impact of the transfer of ownership rights on the performance of economic agents as one of the main reasons to proceed to large-scale privatizations. In this case too privatization is meant to induce advantages in terms of static (productive and allocative) and dynamic efficiency (Grosfeld, 1990). Productive efficiency will improve since private principals have stronger incentives to deal effectively with moral hazard than public principals, although none of them can avoid the problem of asymmetric information. Increases in allocative efficiency go back to the old Von Mises' argument that in order to have resources allocated efficiently, we need prices representing efficient valuation of relative rates of return, which can be determined only on capital markets. However, at least in theory, this kind of increase could also be obtained if the state owns the means of production.\(^10\)

\(^{8}\) The competitive equilibrium attained by the free market generates economic efficiency in the Pareto sense.
\(^{9}\) Public ownership indeed makes the owner-manager relationship more complicated because the chain of principals and agents is expanded, objectives are politically determined and conveyed by an administrative structure to management (see Estrin and Perotin, 1991). But the relative efficiency of public against private ownership seems to depend more on other factors: the efficiency of capital market monitoring, the political and constitutional system, the information and sanctions available to policy-makers and the nature of the market for managerial skills. Estrin (1994) also recalls that theoretical models of decentralized planning or workers' self-management isolated equilibria identical to those attained under competitive capitalism.
\(^{10}\) Nuti (1989) elaborates a model in which the public enterprises, transformed into joint-stock companies, are permitted to detain reciprocally shares, while profit-maximizing specialized state institutions (holdings, banks, etc.) supervise management performance with results similar to those obtained in the capital market.
Furthermore, the increase in dynamic efficiency seems more due to the existence of particular institutions than to a specific form of property. Certainly a private market economy offers a continuous evaluation of the firm’s assets by the capital market and favours the selection of organizations which have the best combination of trial-generation and error-elimination capacities (Grosfeld, 1990), thus stimulating the introduction of technological progress and new productive processes. However, if it is true that the anti-innovation bias is a feature of the Soviet-type economy, in theory the functioning of capitalist-like institutions could also be simulated in a different institutional context.

The extensive work on privatization in Western Europe (above all, Vickers and Yarrow, 1988, on Great Britain) indicates that privatization must be accompanied by adequate measures to reduce and contain market power. The increase in efficiency deriving from the change of the incentives depends crucially on the level of competition and the degree of regulation of the environment in which the enterprise operates. The degree of competition and the efficiency of the regulatory system seem to have a greater impact on enterprise performance than ownership in itself.

In the case of transitional economies, this aspect has been overlooked, especially by those economists in prominent positions for influencing policymakers. For instance, Jeffrey Sachs, famous economic counsellor of many Eastern European governments, recommends maximum priority being given to privatization, regardless of the state of infrastructures, market conditions, lack of institutions capable of effectively managing the privatization process itself (Lipton and Sachs 1990, Sachs 1992). Important market failures characterized post-communist economies at the beginning of the transition (and to a large extent still do). The structure inherited from

11 Competition can be increased by removing barriers to entry, restructuring the dominant enterprise, discouraging strategic behaviour of the enterprise towards the regulatory authority. Vickers and Yarrow, 1988, pp. 426-27.
the past regime presented features of great concentration, with very few enterprises of enormous dimensions in the main productive sectors. Under those circumstances, as argued by Bös (1993, pp. 103-104), if the privatized firm is a monopoly, privatization would not induce all the positive results recalled above. Privatization will indeed change the nature of the principal-agent relationship and the objectives (from party-political planning to profit maximization). However, it may lead to allocative inefficient high prices which have to be traded off against the productivity increases resulting from privatization (Bös, 1993, p. 104). This would suggest that some degree of restructuring should take place before privatization.

The issue of restructuring before or after privatization has been present in the debate on transition. The need to proceed to some degree of restructuring of state-owned enterprises before privatizing them has been justified mostly with the necessity to modify the industrial structure inherited by the communist regime, as centrally planned economies were characterised by enterprises of very large dimensions, with a strong bias in favour of heavy industry, a very small service sector and an abnormally large proportion of output geared to the CMEA market. However, it is generally recognized that a thorough restructuring of the state sector would entail enormous costs for the state budget and would delay further the privatization process. Furthermore, as suggested by Estrin (1994), in an environment of tight state credit, privatization holds out the pressure for access to relatively cheap new funds and private owners are probably more willing and able to withstand pressure for wage increases.

12 If the privatized firm operates in a competitive environment, profit maximization corresponds to welfare maximization, hence a change from party objectives to profit maximization is a move for the better. Bös, 1993, p.104.
2.2. Ownership and control

Very often in developed market economies, management functions are detached from property, or in any case by the right to receive residual income from the activity of the enterprise. The issue of the separation between ownership and control is of the utmost importance also for economies in transition, where there is a clear need to establish arrangements giving owners and creditors some control over enterprises. The absence of effective governance might have serious consequences, since the managers could work in the interests of major stakeholder (the labour force or the management itself) and avoid any kind of restructuring.

The outcome of privatization process in the CEECs indicates that in addition to the need to make the regime change irreversible by transferring all (or a very large part of) state assets into private hands, there is the specific necessity (and willingness) to benefit insiders from the process of privatization. Only a limited constituency of people, the argument goes, will benefit from the transition process. There is therefore the need to motivate groups (workers &/or managers of state-owned enterprises) in support of the process of transformation through privatization. In the absence of this particular incentive, once privatization is proclaimed a main political objective, the public sector loses a long-term perspective and residual legitimation. Managers have an incentive to play end games, that is, enrich themselves at the expenses of the enterprise assets before a new private owner takes control.

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13 The relationship between manager and owner is commonly represented in terms of an agency problem.
14 The importance of this factor is increasingly recognized in the literature; see for instance, Estrin, 1994, Frydman and Rapaczynski, 1994. A stimulating paper by Bogetic (1993) shows how minority employee ownership combined with a free market for shares could be advantageous in the process of privatization by lowering political resistance to privatization.
15 On this point see also Chilosi, 1993a.
The discipline of capital market is often indicated as a way to devise arrangements empowering and motivating outsiders to engage in enterprise control. Two main alternatives are often mentioned: takeovers or other aggressive corporate control mechanisms, and the creation of a group of core investors. The first is very unlikely to work in an environment characterized by an underdeveloped capital market. The second is probably more viable, but not immediately applicable for CEECs, where stock markets are thin, highly illiquid and volatile and cannot yet play a role as a mechanism for corporate control and allocation of financial resources.16

It is common believe that in economies in transition a supervisory role could usefully be performed by financial institutions. Two alternative models have been considered: a market-based model and a universal banking system. A recent study by Steinherr (1992) suggests some complementarities among the two models, more than their mutually exclusive character. The hypothesis is based on the observation that the relative importance of different segments of the financial system changes with the level of development. At an early stage of industrialization, the financial system is mainly bank-oriented: per capita, income is low, savings are collected and allocated by banks, while enterprises tend to retain and reinvest their savings. As income increases, capital markets begin to play a larger role and other savings-collecting institutions start to appear. At a more advanced stage, when the relative share of manufacturing on total output declines and the share of the service sector increases, there is room for a greater role for the capital market. Investors are more willing to invest in financial assets with a higher risk and smaller degree of liquidity.

At the early stage in their transformation, most CEECs seem to have moved towards the universal banking model. The satisfactory performance

16 Moreover, markets are prone to speculative bubbles and collapses, and, as the recent experiences of MMM in Russia and Caritas in Romania suggest, vulnerable to fraud.
of a model based on debt-monitoring, however, means that it would need to solve several problems which are currently affecting economies in transition. In the first place, the capability of creditors to influence enterprise behaviour depends in all economic systems on legal provisions for bankruptcy. So far in economies in transition bankruptcy legislation has been applied to different extents in different countries: in a more rigorous way in the Czech Republic or in Hungary, in a rather loose way in the Russian Federation. Moreover, under the present conditions, there are doubts that banks are at all equipped to play this kind of role. The banking system in Central and Eastern Europe is still largely dominated by under-capitalized, state-owned banks, loaded with bad debts and inter-enterprise arrears. In order to initiate and supervise a programme of restructuring of state-owned enterprises, bad debts should be eliminated and existing banks should be recapitalized. Several proposals have been advanced for cleaning the bad debt off the banks' balance sheets. The so-called centralized strategy relies essentially on the transfer of the bad debt to a central body, which generally is a government-sponsored institution created specifically for this purpose. The institution has the responsibility for debt-restructuring and the eventual liquidation of the state-owned enterprise. A simultaneous recapitalization of the bank is envisaged to make up for the loss of assets. In the so-called decentralized approach, the banks themselves manage the debt-restructuring, by separating the bad loans from the other loans. This can be done by establishing a separate department with a special management team within the bank, or by creating a spin-off subsidiary to which the bad debts could be transferred. To my knowledge, Poland is the only post-communist country that has so far relied more on the decentralized approach.  

17 An extensive review of the problems linked to the transformation of the banking system can be found in Blommestein and Lange, 1993.
2.3. Privatization and the state budget

In a market economy, privatization of loss-making or heavily subsidized state-owned enterprises is commonly perceived as having a positive impact on fiscal stance. The case is often mentioned that termination of subsidies or the disposal of loss-making activities managed directly by the state will induce savings in the state budget.

However, it can be shown that under a specific set of realistic assumptions, this intuitive statement is wrong. Assuming that the state receives for the enterprise a sum that is equal to the present value of the foregone net income, it can be demonstrated (see Mansoor, 1988) that fiscal stance is in most cases permanently unaffected by privatization. Indeed, unless enterprise performance increases as a result of privatization, i.e., if the firm is run more efficiently in the private sector, privatization may worsen the medium-term budgetary outcome.

The economic literature maintains that changes in the conventional deficit are not an appropriate indicator of the net effect of privatization (see for instance Buckland and Davis, 1984; Mayer and Meadowcroft, 1986; Mansoor, 1988). The sale of public assets reduces, at least in the short term, the public sector borrowing requirement, but changes in the overall deficit do not take into account the effects of sales on the net worth of the government. At the same time, privatization has an impact on the intertemporal distribution of the public deficit, easing the liquidity constraint in the short term, thus providing a margin for cutting taxes or increasing expenditure. This policy, however, might need to be reversed in future years.

At macroeconomic level, a further negative feature can be identified. While privatization revenue accrues almost immediately to the budget, foregone income needs to be discounted. The political preference being given to privatization may lead to excessive discount rates being applied to
future net income streams, thus underestimating its contribution in the long run. Privatization could, on the contrary, reinforce the government credibility, if it is interpreted as a component of a restrictive fiscal policy. In this respect, it could also induce positive effects on public debt, particularly by contributing to reduce inflationary expectations (see Chiri, 1989, p.114).

Most of the issues raised above are of a general nature and apply also to economies in transition. In addition, let me mention a few more specific factors that need to be taken into account in the case of post-communist economies. Consensus seems to have emerged in the recent debate on the fact that receipts from privatization are not an appropriate source of budget-financing for economies in transition. As indicated by Bolton and Roland (1992, p. 288) the main obstacle towards the implementation of a policy based on sales of state assets is what the authors call the 'stock-flow constraint': in a closed economy, without pre-existing private wealth or capital markets, the most the government can get from selling a stock of assets is a flow of savings. In addition, the inter-temporal consequences of privatization on public finances are affected by the institutional changes taking place during the transition. In particular, the taxation system is undergoing a deep transformation in all post-communist countries. The outcome of privatization on the state budget will depend strongly inter alia on the capacity to levy and the efficiency of the new system of taxation, that in turn would require some degree of current and perspective macroeconomic stability. A further specific obstacle for economies in transition is the difficulty to proceed to a correct evaluation of assets and consequently to devise 'correct' prices at which assets should be offered,

\[18\] Bolton and Roland propose to alleviate the stock-flow constraint by allowing the government to sell state assets in exchange for claims on future cash-flows generated by the assets. This point is discussed further in section 3.
given the existence of an environment characterized by the lack of proper accountancy criteria and by a distorted structure of relative prices.

2.4. Alternatives to privatization

Before turning to an overview of the privatization process in Central and Eastern Europe, let me point out very briefly two alternatives to privatization of existing state assets which emerged at an early stage of the debate, but, however, did not receive much attention from policy-makers in Central and East European countries.

The recognition that the state sector presents some built-in tendencies against restructuring has led some authors (among others, Kornai, 1991) to put more emphasis on the expansion of the new private sector. The main problem which the proposal is trying to address concerns the way in which the state sector can be controlled and run until its demise. According to this view, which is sometimes termed 'evolutionist', the state sector should have been allowed to die a natural death and no front-loaded privatization should have been attempted. The main rationale is to avoid the huge social costs that a thorough and rapid dismissal of the state sector would have caused in many post-communist economies. In this approach, the private sector is emerging almost exclusively out of the spontaneous development of private activities. As its growth progresses, it should be able to absorb labour force previously employed by the state sector, attracting, in a sort of 'natural selection', its most skilled and entrepreneurial components first. The main problem the proposal is facing is the envisaged coexistence of a large (and powerful) public sector with a small private one for an indefinite, but probably fairly long period of time. The state, by imposing restrictive policy measures over state-owned enterprises, should guarantee to the developing private sector a fair treatment and at least equal access to
resources as the public sector. And it is the excessive reliance on a strict regulatory power of the state during the transition that has been seen as the main shortcoming of this approach.  

In another proposal, Chilosi (1993a and 1993b) describes pros and cons of alternatives schemes based on privatization of management and control without a corresponding privatization of ownership. The main scheme (Chilosi 1993b, pp. 13-14) delineates a non-discretionary privatization process based on depriving state-held shares of voting rights. State enterprises are first transformed into joint-stock companies, while a constitutional law deprives the shares which remain in state hands of voting rights. Then a certain percentage of the capital of the firm is sold through auctions to the highest bidder. The remaining state quotas are subsequently auctioned until the state share is reduced to the required proportion. Incentives for an efficient management of the enterprises can be devised, for instance, by means of option rights to existing private shareholders depending on the profitability of the company, or entitlement to appropriate residual income. In the intention of its proponents, the application of a similar scheme would have conjugated an instantaneous privatization of management with a more gradual privatization of ownership. Arguably, conferring the entire decision-making power to the minority of shares (those in private hands) could encourage risky ventures. However, a delayed move towards a massive privatization could have implied a reduction in the costs deriving from the complete neglect of the state sector, while advantages could have been derived for the state budget through a more gradual offer of assets on the market.

19 The 'evolutionists' view' is criticized, among others, by Frydman and Rapaczynski, 1994, pp. 200-204.
3. Methods of Privatization

Different privatization methods have been used both in developed and developing countries. Some of them are summarized in Table 1, where an attempt is made to identify options and possible distinctive features of each scheme.

The two most common procedures followed for sale privatization are: offer for sale or tender offer. Either shares or assets can be offered on sale. An offer for sale takes place at a fixed price and requires an accurate estimate of the value of the enterprise. As indicated in the Table, a number of options are possible as regards participation (allowing foreigners to participate or not), and restrictions on size of individuals or foreign shareholding. A preliminary decision has to be taken with regard to restructuring of the enterprise, both in terms of operational restructuring and market power. Public offerings present advantages in terms of substantial revenues for the budget, non-discretionality and widespread shareholding. Their use, however, is limited by a strong dependence on primary markets, availability of capital and investors.20 Private sales introduce discretionality and lack of transparency into the process, but are generally considered a feasible alternative in underdeveloped equity markets.

In a tender offer, bids are normally invited at or above a stated minimum price. It has the advantage of not requiring a precise estimate of the value of the firm, although it is often a complex procedure which might discourage the participation of small investors.

Some authors regard auctions as an optimal solution to the problems posed by privatization. Bolton and Roland (1992) suggest that participation

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20 A further disadvantage may be represented by possible crowding-out effects. This will depend, however, on the use of sale proceeds.
<table>
<thead>
<tr>
<th>METHODS OF PRIVATIZATION</th>
<th>PROCEDURE</th>
<th>OPTIONS</th>
<th>FEATURES</th>
<th>USE IN T.E.</th>
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</table>
| 1) Public offering of shares | - fixed price sale  
- tender  
- stock flotations | - domestic  
- international  
- restriction on size of individual shareholders or foreigners part offerings underwritten | - substantial revenue  
- widespread shareholding  
- openness & transparency of procedures  
- strong dependence on primary market (or market substitute)  
- need to restructure loss-making enterprises  
- crowding out? = [use of proceeds] | - Hungary  
- Poland |
| 2) Private sale of shares | - bidding, with pre-qualification of bidders  
- direct negotiation | - domestic  
- international  
- restriction on size of individual shareholders or foreigners part | - discretionary procedures  
- lack of transparency  
- feasible alternative in underdeveloped equity market | - Czechoslovakia  
- Poland  
- former GDR |
| a. Reorganization into component parts | - break up into several legal entities  
- transformation into holding company  
- sale of productive facilities in single or groups of units | - sale by parts  
- restructuring / negotiated / sectoral | - flexibility  
- potential investors more attracted by parts than aggregate  
- allows use of different methods for different components  
- breaking of (potential) monopolies | |
| 3) Sale of government or enterprise assets | - competitive bidding  
- auction  
- direct negotiation | - sold privately  
- contributed by government to new company with private sector  
(\checkmark shares \Rightarrow sold)  
- assets sold individually \Rightarrow privately  
- together as a new corporate entity | - assets sold without correspondent liabilities | - Czechoslovakia (Dutch auctions) |
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<th>METHODS OF PRIVATIZATION</th>
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<tr>
<td>4) New private investment in SOE or debt-equity swaps</td>
<td>- capital increase (equity ownership open to private sector)</td>
<td>- public offer of subscription - private offer - various classes of shares - new issue and offering of existing government shares</td>
<td>- funding problems of undercapitalised enterprises - generally no sales proceeds for state new funds used for rehabilitation &amp; restoration of working capital - extension of SOE capital without state divestment</td>
<td>Hungary</td>
</tr>
<tr>
<td>5) Management / employee buy-out:</td>
<td>- creation of a holding company through an equity issue subscribed by management &amp; employees - holding company acquires SOE to be privatized</td>
<td>- main alternative to liquidation - need for large (projected) cash flow or other security</td>
<td></td>
<td></td>
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<tr>
<td>a. MBO: Management buy-out</td>
<td>- acquisition of a controlling shareholding by group of managers</td>
<td></td>
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<tr>
<td>b. LBO: Leveraged management/employee buy-out</td>
<td>- acquisition financed by credit - assets of acquired company used as security</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. ESOP: Employee stock ownership plan</td>
<td>- employees acquire blocks of shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Management buy-ins (also leveraged)</td>
<td>- an individual or group of individuals outside the firm buys the enterprise, but offers concrete restructuring programmes, becoming the new management of the firm</td>
<td>- newly issued shares or expansion of capital base - setting up a &quot;workers ownership trust&quot;</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- mostly relevant for workers cooperatives</td>
<td></td>
<td>Planned: Hungary, Lithuania</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Planning: Macedonia</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
in auctions should also be allowed for individuals with limited wealth but potential managerial capacity. By way of non-cash bids, individuals could be allowed to borrow against future earnings creating a wider participation and potentially contributing to increase the productive efficiency of the entire process. The scheme also has the advantage of eliminating the stock-flow constraint described above, whereby the state, by selling the stock of assets, can only receive a flow of savings.

Management/employee buy-outs have been used extensively both in developed and developing countries. The methods, which present at least four variants (see Table 1), generally envisaged the creation of a holding company through an equity issue subscribed by managers and employees. The holding acquires the state-owned enterprise being privatized. Management/employee buy-outs represent a main alternative to liquidation, offer advantages in terms of productivity incentives, but are most often seen as ways of minimizing lay-offs and restructuring. In order to be successful, the process requires a competent and skilled management and a stable workforce.

A unique form of management buy-out that has been observed in Central and Eastern Europe is spontaneous privatization. An active role by state organizations can be envisaged (as in Hungary), or the process can be initiated and carried out by enterprises themselves. The common way in which spontaneous privatization takes place is by way of founding new companies (by turning part of the property into joint stock of limited liability companies) making use of state assets. Alternatively the creation of new firms can be encouraged. The first phase of the transition in Central and Eastern Europe has witnessed widespread phenomena of uncontrolled and 'spontaneous' privatization (See Johnson and Kroll, 1991). Spontaneous

---

21 This solution, however, presents problems of moral hazard. There is an incentive to bid with borrowed funds which, in the event of a successful bid, is returned. Otherwise the bidder can disappear without personal costs of any kind.
privatization was made possible by the existing legal framework governing state-owned enterprises, under which ownership rights were in the hands of the enterprises themselves. Managers (and to a lesser extent workers) have been able to use the legislative vacuum for stripping the enterprise's assets. According to Johnson and Kroll, however, the acquisition of property rights *de facto* by the managers did not correspond, at least in this first phase, to an appropriation *de jure*. They maintain that only residual property rights were acquired, those that in the past granted direct and arbitrary interventions of the state or the ruling party in the day-to-day running of the enterprises. Transfers of this kind have for the most part survived the following institutional changes.

Instead of being sold, state assets can be leased, i.e. the right can be granted to use a specified good for a fixed period of time with the obligation to pay a fee to the owner. This method does not involve divestiture of state assets or transfer of ownership and can also be thought of as a temporary measure before privatization.

Finally, with respect to the recent experience of economies in transition, alternative privatization proposals based on distribution schemes have been devised, often referred to as give-away, or vouchers or mass privatization schemes. These schemes can be usefully regrouped into three main categories:

a. those envisaging the distribution of assets directly to the population at large;

b. those foreseeing the creation of financial intermediaries (investment, mutual or privatization funds) and the distribution of their shares to the population;

c. those conceiving the establishment of holdings to manage a group of state-owned enterprises.
Mass privatization is based on the free distribution (or at a nominal fee) of vouchers or certificates which each citizen receives and which give entitlement to some equity share. It is normally a fraction of state capital which is distributed. Some enterprises remain under state control and are privatized according to one or more of the standard methods discussed above.

These kinds of schemes present a number of positive features. First, they can be implemented relatively quickly and therefore allow a rapid eradication of state property. The non-discretionary nature of the process presents advantages in terms of transparency of the procedures and avoidance of corruption. At the end of the process, the distribution of wealth accumulated under the previous regime may turn out to be more 'equitable', therefore helping to gain public support for the entire privatization (and reform) process. Schemes of this kind can be implemented even if there are not enough resources in the hands of the population necessary to buy goods being privatized, a case relevant for transitional economies. Vouchers or certificates can have a pre-determined monetary value and may or may not be tradable between individuals. They could be used to bid for shares in auctions for a particular group of enterprises or sectors, thus also avoiding the intricate problem of evaluation of stocks, the value of which is left to be determined on the market. However, the public at large is unlikely to be willing (or even able) to bid. Financial intermediaries can be created, which manage large amounts of vouchers and behave as institutional investors. A large variety of schemes is characterizing the experience of post-communist economies.

22 For a review of costs and benefits of mass privatization schemes, see Nuti, 1994.
4. Privatization Strategies in Post-Communist Economies

Private property was present also in centrally planned economies, mostly in the form of private savings or bequests, ownership of small shops or dwellings. In some countries, private activity made up a significant part of the economic activity (for instance in the case of Polish agriculture). This can explain the fact that at least *ex ante* privatization schemes varied markedly among countries and privatization proposals have been appreciated to a different extent by the population. There are, however, a number of common institutional features which characterize the experience of economies in transition.

All economies, with the exception of Latvia, established a central privatization institution charged with the supervision of the privatization process. More recently, an increasing number of countries has also created trust funds or agencies for the management of the assets not yet divested. All enterprises of a large dimension underwent a process of 'corporatization', i.e., they were transformed into joint-stock or limited liabilities companies before being privatized. Some degree of financial restructuring has been performed, especially for clearing part of the inter-enterprise arrears developed since the inception of the transition. To a lesser extent, some reduction in the dimension of the enterprises has also taken place, especially breaking up actual or potential monopolies. However, in almost all cases, operational restructuring has been left with the new owners. Small-scale privatization has been a rather smooth and relatively rapid process. Regardless of substantial differences in the initial definition of privatization

---

23 The aim of this section is only that of recalling the main features of the privatization paths followed by economies in transition. Several articles and books have been published recently describing these processes in detail. An excellent survey on a country by country basis can be found, for instance, in Earle, Frydman and Rapaczynski (1993) and Frydman, Rapaczynski, Earle et al. (1993a and 1993b).
strategies, economies in transition ended up using all privatization techniques, albeit to a different degree.

The use of standard privatization techniques - public or private offering - has for the most part been constrained by some of the institutional features of centrally planned economies. Borensztein and Kumar (1991, pp. 304-305) indicate that distorted prices, trade and management arrangements under the previous regime made it virtually impossible to arrive at proper estimates of the firm’s market value and its profitability potential. Also, private savings in Central and Eastern European countries were generally limited, or in any case not significant enough to buy the very large amount of assets being alienated. Moreover, in many countries, price liberalization has been accompanied by a strong increase in price inflation, which has substantially reduced these savings. Nevertheless public and private offerings have been utilized to a limited extent in the Czech Republic, Hungary, Poland and the Slovak Republic.24 Sales of enterprises, as opposed to free distribution of assets, have been given priority in Hungary, where considerable foreign participation has also been encouraged, in contrast to other countries, especially the Czech Republic and Poland. Finally, a unique form of privatization through sale of property has taken place in Poland, the so-called 'privatization by liquidation'25 whereby state-owned enterprise is disbanded and its assets are sold (or contributed) to a new private company in most cases formed by employees of the firm itself.

The most innovative feature of privatization in post-communist economies is certainly the adoption of mass privatization schemes. With the exception of the former GDR, all Central and Eastern European countries have adopted some forms of mass privatization. There are a number of features which should be singled out.

24 Given the completely different nature of the transition, in the former GDR usual forms of privatization have been used more extensively.
Despite the fact that voucher schemes are the flagship of privatization in all transitional economies, the enterprises privatized in this way form a minority. Even in the countries where these schemes have found wider application, i.e., the Czech Republic and Lithuania, only a small proportion (36% and 20% respectively) of state-owned enterprise are being privatized by means of voucher distribution. Some of the remaining enterprises will remain state-owned, others are being privatized according to standard methods.

A number of investment funds have been established in all countries to serve as intermediaries in the privatization process. However, while in some countries (Russia, the Czech and Slovak Republics) the choice of whether to bid directly for shares or to do it through an intermediary was left with the citizens, other countries (e.g. Poland and Romania) opted for closed-end investment funds or holdings created by the government.

Where investment funds have started to operate (e.g. the Czech Republic, Russia, Lithuania) privatization has gained speed and popular participation has increased. Part of the success has been explained in terms of the funds' advertising campaigns, which are raising expectations of substantial returns on investments. Despite the danger linked to the possibility of a widespread cashing-in of the promised gains (very often short-term) and the consequent fear of collapse of the fragile financial system the process so far has developed rather smoothly and episodes of mismanagement seem to be more the exception than the rule. The investment funds are also emerging as the main shareholders of privatized companies.

In most cases, secondary trading of vouchers is not allowed and they can be transferred only under particular conditions, mostly among members of

26 In the Slovak Republic, the proportion is higher (65%), but apparently enterprises contributed only a fraction of their shares for vouchers. See CCEET (1993), p.17.
the same family. *Vice versa*, in the case of Russia, vouchers issued with R.1,000 nominal face value were made tradable immediately on issue. Vouchers' re-tradability and the decentralized procedures in auctioning the enterprises are singled out as the main reasons for accelerating privatization in Russia (see Lissovolik (1993), pp. 11-12).

Finally, schemes also differ in terms of foreign participation. While in the Czech and Slovak Republics, foreigners cannot participate in the auctions, in Russia their participation is allowed, although with some limitations.

5. A Preliminary Assessment

On the whole, the evaluation of alternative strategies of privatization adopted by the various Central and Eastern European countries is made difficult by the fact that privatization is a relatively new phenomenon in economies in transition. The fact that post-communist economies are ending up using all conceivable privatization techniques, makes it difficult to assess which strategy presents the best performance. Moreover, a complete evaluation of aims and results of privatization will only be possible in a few years' time, when the process will come to an end and more statistical evidence will be made available. Nevertheless, it might be useful to single out some elements for a preliminary assessment. According to Dhanji and Milanovic (1991), alternative strategies should be compared taking into account their performance with respect to:

a. equity;

b. speed of the privatization process;

c. ability to control and supervise managers' behaviour;

d. capacity to generate budget revenue.
The adoption of mass privatization schemes certainly goes in the direction of a more equitable distribution of the national wealth accumulated under the previous regime. Some countries have imposed important limitations, based on citizenship, or years of permanence in a specific job, which are running against a principle of equity. In other cases (i.e. Russia) the employees seem to be able to benefit more than outsiders from the privatization of their enterprises. These concessions can be easily explained in political terms (see the consideration developed in section 2.1), but probably violate the rationale of an equitable distribution of wealth.

It is by now clear that in transitional economies, privatization is a much slower process than anticipated. The ambitious targets (number of economic units to be privatized in a given time span) set at the outset of the privatization processes have nowhere been realized. Table 2 summarizes targets and preliminary results of both small and large-scale privatization under way in economies in transition and recalls some of the central institutions involved in the process.

With respect to large-scale privatization, by mid-1993 the best performing countries (the Czech and Slovak Republics) were able to transfer into private hands over 80% of the total number of enterprises to be privatized. However, all other Central and Eastern European countries were lagging very far behind and in some cases - in Albania, Latvia, Romania, as well as in many former Soviet republics - large-scale privatization has just started.

Even in the case of small-scale privatization, which, however, has been a rather successful process in all countries, deadlines have been postponed, or, as documented in Table 2, the process remains to be completed.

At the same time, the transfer of state assets to the private sector has been paralleled by a rapid growth of a new private sector which has greatly reduced the scope for a complete privatization of the existing state property.
<table>
<thead>
<tr>
<th>country</th>
<th>main supervisory bodies</th>
<th>SMALL PRIVATIZATION</th>
<th>LARGE PRIVATIZATION</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>n. of units to be privatized</td>
<td>n. of units privatized</td>
<td>%</td>
</tr>
<tr>
<td>Albania</td>
<td>National Agency for Privatization</td>
<td>n.a.</td>
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<tr>
<td></td>
<td>Commission for Privatization under the Council of Ministers</td>
<td></td>
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<td>Bulgaria</td>
<td>Privatization Agency</td>
<td>30-40,000</td>
<td>n.a.</td>
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<td>Sectoral Ministries</td>
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<td>Czech Republic</td>
<td>Ministry for Administration &amp; Privatization of National Property</td>
<td>31,914</td>
<td>22,001</td>
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<td></td>
<td>National Property Fund</td>
<td></td>
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<tr>
<td>Estonia</td>
<td>Department of State Property</td>
<td>1,212</td>
<td>676°</td>
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<td></td>
<td>Estonian Privatization Enterprise</td>
<td></td>
<td></td>
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<tr>
<td>Hungary</td>
<td>State Property Agency</td>
<td>10,000</td>
<td>7,637</td>
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<td></td>
<td>State Asset Management Plc</td>
<td></td>
<td></td>
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<tr>
<td>Latvia</td>
<td>Ministry of Economic Reform</td>
<td>8,000</td>
<td>302</td>
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<td></td>
<td>Sectoral Ministries</td>
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<tr>
<td>Lithuania</td>
<td>Central Privatization Committee</td>
<td>3,300</td>
<td>1,832</td>
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<td></td>
<td>Regional Privatization Committees</td>
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<td>Poland</td>
<td>Ministry of Privatization</td>
<td>n.a.</td>
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<tr>
<td></td>
<td>Sectoral Ministries</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Regional &amp; Municipal Authorities</td>
<td></td>
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</tbody>
</table>

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<table>
<thead>
<tr>
<th>METHODS OF PRIVATIZATION</th>
<th>PROCEDURE</th>
<th>OPTIONS</th>
<th>FEATURES</th>
<th>USE IN T.E.</th>
</tr>
</thead>
<tbody>
<tr>
<td>6) Spontaneous privatization:</td>
<td>- found companies making use of state assets:</td>
<td>- SOE continues operations with remaining assets</td>
<td>- need competent &amp; skilled management and stable work force</td>
<td>- All countries</td>
</tr>
<tr>
<td>- no state directives, but initiated and carried out by enterprises themselves</td>
<td>- part of property turned into joint-stock or limited liability companies</td>
<td>- former enterprise left with functions of asset management</td>
<td>- incentive productivity</td>
<td></td>
</tr>
<tr>
<td>- state organizations active</td>
<td>- found individual companies with factories, plants, administrative depots</td>
<td>- new owners</td>
<td>- unknown (weak?) potential cash flow</td>
<td></td>
</tr>
<tr>
<td>7) Lease</td>
<td>- right to use specified facilities for a fixed period</td>
<td>- temporary measure: intermediate phase before privatization, i.e., turning unprofitable into profitable venture before privatization</td>
<td>- no transfer of ownership</td>
<td>- China</td>
</tr>
<tr>
<td></td>
<td>- obligation to pay a fee to owner</td>
<td></td>
<td>- no divestiture of state assets</td>
<td>- Latvia</td>
</tr>
<tr>
<td>8) Give-away schemes</td>
<td>- compensation vouchers</td>
<td>- direct</td>
<td>- lease assures the full commercial risk for operating the assets</td>
<td>- All countries for retail trade and catering</td>
</tr>
<tr>
<td>- ownership certificates</td>
<td>- to employees</td>
<td>- no revenue for the state</td>
<td>In progress: Czech Republic, Estonia, Kazakhstan, Lithuania, Romania, Russia, Slovak Republic, Ukraine</td>
<td></td>
</tr>
<tr>
<td>- privatization cheques</td>
<td>- to public</td>
<td>- in theory:</td>
<td>Planned: Albania, Armenia, Belarus, Hungary, Latvia, Moldavia, Poland, Slovenia</td>
<td></td>
</tr>
<tr>
<td>- investment vouchers or coupons</td>
<td>- indirect:</td>
<td>- rapid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- certificates of investment- or ownership funds</td>
<td>- firms allocated to intermediaries</td>
<td>- equitable</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>- free</td>
<td>- not discretionary</td>
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<td></td>
<td>- nominal fee</td>
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<td>- on credit</td>
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<td></td>
<td>- by instalments</td>
<td></td>
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<tr>
<td></td>
<td>- transferable or not</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

Notes:

a) Plans have changed repeatedly. Mostly based on press reports.

b) With the exclusion of compensation vouchers, distributed in 1992.

Source:

Author’s elaboration based on: Vuyiške, 1988; UN-ECE, 1993; Press reports.

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23/12/1993
The dispersion of ownership resulting from the adoption of mass privatization schemes could represent an impediment to efficient control and supervision of managers' behaviour, especially in an environment characterized by a rudimentary structure of corporate governance. The adoption of the different models of managerial supervision discussed in section 2.2 may lead to different results in different countries, although it seems too early to identify whether it has been possible to derive an increase in efficiency actually from the transfer of property rights. Moreover, given the thorough nature of the changes under way, it will be impossible even in the future to trace back which part of the increase could be ascribed to the change in ownership and which to other systemic transformations carried out during the transition to a market economy.

As discussed above, the possibility of using privatization revenues to improve the state of public finance remains a rather controversial issue even for market economy. Economies in transition do not seem particularly concerned with the need to use privatization proceeds for improving their fiscal stance at least in the short term. So far the process of privatization has represented a net loss for the state budget and as the transition has entailed enormous social and economic costs, one could wonder whether revenue from privatization could not have been used to reduce growing state budget deficit, public debts, or at least their foreign component.

7. Conclusions

The paper has argued that the expansion of the activity of the private sector in post-communist economies has been perceived almost exclusively as the privatization of vast sectors of the economy in the shortest possible time. Privatization is certainly crucial in consolidating the passage of a state-
controlled economy to a profit-oriented market system. The attention paid to the transfer of ownership rights is also one of the main differences with respect to past reform experience, when the issue of property rights was explicitly excluded because of ideological reasons and repeated attempts were made to improve the performance of the system without questioning state ownership of the means of production. Indeed, today the failure of previous reforms is often attributed to the lack of property-rights transformation.

However, even (and arguably to a greater extent) in formerly planned economies, the increase in economic efficiency generally attributed to privatization very much depends on the competitiveness and the degree of regulation that characterizes a given economic system. Privatization must be paralleled by the introduction of measures which regulate market power and institutions must be created for an effective control of the privatization process.

The paper has also briefly reviewed the main issues of the privatization processes in Central and Eastern Europe to conclude that privatization is progressing at different speeds in different countries. The widespread use of give-away schemes, easily justifiable in political terms, has entailed costs for the budget, while, at the same time, governments in transitional economies have deprived themselves of a possible source of revenue, often in the presence of growing budget deficits largely deriving from the need to tackle the economic and social costs of the transition. A careful scrutiny of the costs and benefits of privatization, however, would only be possible with the availability of a more comprehensive set of data.
REFERENCES


<table>
<thead>
<tr>
<th>Country</th>
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<th>Small Privatization</th>
<th>Large Privatization</th>
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<td></td>
<td>- Private Ownership Fund</td>
<td>24.2</td>
<td>0.5</td>
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<td></td>
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<td>LEV 15 bn</td>
<td>n.a.</td>
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<td></td>
<td></td>
<td></td>
<td>n.a.</td>
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<tr>
<td>Russian Federation</td>
<td>- State Committee for Management of State Property</td>
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<td>- Regional &amp; Municipal Funds</td>
<td>33.3</td>
<td>19.1</td>
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<tr>
<td></td>
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<td></td>
<td></td>
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<td>41,394</td>
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<td>- National Property Fund</td>
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<td>1,476</td>
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<td></td>
<td>- District Privatization Committees</td>
<td>81.3</td>
<td>79.8</td>
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<td></td>
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<td>Kc 13.7 bn</td>
<td>n.a.</td>
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<td></td>
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<td></td>
<td>n.a.</td>
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<tr>
<td>Ukraine</td>
<td>- State Property Fund</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Notes:

a) Including larger units.
b) Includes: corporatization; self-privatization; investor- or enterprise- or state-initiator transformation.
c) The figure may refer to the book value of assets.
d) Number of state firms in 1990.

Source:

CCEET (1993c, pp. 27-52); UN-ECE (1992, p. 195); Semeta (1992); Press reports.

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23.12.1993


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