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Privatisation in Central and Eastern Europe

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1. Privatization in Central and Eastern Europe

Privatization in this essay refers only to the sale of firms, and is defined as the transfer of the controlling interest from the state to private owners. This differs from the definition in several East European countries, where the transfer of any shares by the state to private owners has been called privatization. The definition does not necessarily involve the sale of ownership rights; in Eastern Europe, ownership has sometimes been transferred for free, for example as a restitution to previous owners or through "mass privatization".

The conceptual issues raised by privatization in Central and Eastern Europe do not differ fundamentally from those in the Western debate (see Vickers in this volume). The framework is that of principal-agent theory, which suggests that there may be significant efficiency gains from private ownership. However rather than such ownership changes taking place in the relatively small public sector of an otherwise privately owned and market oriented economy, it is occurring in countries in transition from generations under communism and central planning. Privatisation is therefore only one element in a wider programme of reform, matched in significance by for example price liberalisation, institutional and legal development, the removal of trade restrictions and macro-economic stabilisation (see Fischer and Gelb (1991). This has altered the case for privatisation, strengthening the arguments for speedy and widespread ownership

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changes.

The context of economic reform has led the countries of Central and Eastern Europe to innovate in their methods of privatisation. In the absence of developed capital market institutions and with a drastic shortage of domestic savings, completely new ways of privatising large segments of the economy have had to be developed. One of the important themes for this essay is to examine the ownership consequences of these new methods - mass privatisation - and tentatively to explore whether they might be expected to yield the efficiency gains apparently obtained by privatisation in the West (see eg. Boardman and Vining, 1989).

The remainder of this essay contains five sections. In the following section, we briefly summarise the conceptual analysis of private versus state ownership, with particular reference to the transition. We then go on to consider alternative methods of privatisation, comparing traditional mechanisms with East European mass privatisation. Different modes of mass privatization are outlined in the fourth section, with consequences for ownership structure analysed in the fifth. It is early days for a serious evaluation of the effects of privatisation in Central and Eastern Europe but first indications are noted in the conclusions.

2. Why Privatise in Eastern Europe?

A large literature attests to the advantages of private over state ownership, (see eg. Bos, 1990, Vickers and Yarrow, 1988). In most firms of any size, ownership is separated from control. Owners can be assumed to be interested in increasing their net worth, which implies the firm should maximise its profits. Managers on the other hand will want to use firm-specific rents to achieve their own personal goals - job security, pay, fringe benefits, perks, managerial power and so forth. The conflict of interest causes problems for efficiency because of the asymmetry of information available to the two sides; private shareholders do not know enough about the firm to know whether managers are acting efficiently, or even honestly. If managers are given a free hand, one can assume that efficiency and profitability would suffer.

The free market system offers a number of ways to resolve this conflict of interest. Competitive product markets limit firm-specific rents, and therefore the extent of the damage unconstrained managers can wreak; hence the stress in the Western literature on combining privatisation with liberalization.

Private ownership also means that the behaviour of the firm becomes subject to the scrutiny of capital markets, at least provided ownership titles are not too widely dispersed for the costs of monitoring to outweigh the benefits. Managerial decision-making is monitored by competing traders in equity markets, whose conflicting judgements on potential company performance are summarized in the share price. If the managerial team is thought incompetent or inefficient, the share price will be reduced, putting pressure on managers to improve their performance. These pressures come in part via managerial incentives from shareholdings and bonus payments. They also come from the way that the managerial market operates, with managerial performance in part assessed by movements in share prices. A persistently poor capital market showing can also encourage a take over bid by an alternative management team who seek to persuade owners that they could earn a higher return from the assets.

Few of these mechanisms carry over to state ownership; hence the view that state owned firms will be less efficient. Ownership and control are still separate, with the resulting conflict of interest and informational asymmetry between managers and the state. However, it is much less clear who actually is the owner under state ownership: is it the "national community", a majority of voters; the government or the Civil Service. An important implication is that the state may have multiple objectives from ownership - for example creating employment in depressed regions, holding prices below average costs as an element of prices and incomes policy, or satisfying service criteria. Profits can become a secondary criterion, or indeed an irrelevance. Managerial discretion will be further increased if the government's various objectives for state owned firms conflict or are frequently changed. Government ownership may also imply that budgetary constraints on enterprises are "soft" (see Kornai, (1980)), so managers (and perhaps also workers) can extract rents, secure in the knowledge that taxpayers will ultimately foot the bill. This contrasts with the hard budget constraints imposed on private firms by the possibility of bankruptcy.

The government as owner cannot rely on the highly motivated scrutiny of managerial performance provided by competitive capital markets. Monitoring of public sector managers is in the hands of civil servants, who may not have the expertise and certainly do not have the private incentives of capital market traders. A determined government may be able to some extent to mimic the strong managerial incentive structures of the private capital market, for example by limiting the focus of managerial targets to profitability, by introducing performance related pay and by creating competing agencies to monitor managerial behaviour. However, it is usually argued that the competitively driven informational systems and self-equilibrating governance structures of a competitive capital market probably cannot be substituted for in full. This probably explains the empirical finding that state owned firms are typically less efficient than their privately owned counterparts, and that privatisation improves performance, (see eg. Boardman and Vining (1989), Magginson, Nash and van Randenborgh (1994)).

These arguments have a strong resonance for Central and Eastern Europe pre-reform. The owner of enterprises was effectively the Communist Party, which also controlled the state. The central planning system in principle provided a clear objective for firms - output growth - and a rigorous system of monitoring and incentives (see eg. Ellman (1989)). However, the system also suffered from serious problems of information and incentives (see Kornai (1980)),which led to extremely low levels of efficiency and innovation by Western standards, as well as poor quality standards (see eg. Gregory and Stuart (1988)).

However, the economies of Central and Eastern Europe are not obviously fertile territory for the application of policies which rely on the operation of competitive markets. Product markets are relatively imperfect in many countries and capital markets severely underdeveloped (see eg. EBRD Transition Report, 1995), based on under-capitalised state owned banks and nascent and poorly regulated stock exchanges.

The prospects for privatisation yielding the expected productivity benefits in the short term are therefore not propitious. As a consequence, in the early years of economic reform, there was intense discussion of whether microeconomic restructuring could at first be motivated by price liberalisation and free trade. Privatisation could be left until the track records of existing state owned firms had become established, until the stock of domestic savings in private hands was sufficient to ensure the success of a competitive bidding process for the assets and until capital markets were more developed. This would allow the use of an auction system in privatisation to allocate assets to the highest bidders(bidding thus [illegible] belief they would be able to earn the highest returns from them). The government would also be able to maximise its revenues from the privatisation process,[privatization revenues have been an important element of the policy in the west (see Vickers and Yarrow (1988)].

However, such a policy sequencing assumes that the state is able to manage its assets with some effectiveness in the intervening period. In practice, the collapse of communism left state owned firms with few or no resources, a very weak internal structure to handle the new demands of the marketplace, and no mechanisms for the state to enforce governance. Most firms were effectively controlled by their employees - managers or workers or both.

In these circumstances, the option value of continued state ownership was felt to be very low. The authorities would therefore have had to create new structures to influence enterprise decisions to prevent a gradual dissipation of the net worth of the enterprise sector by workers or managers raising their wages and emolument, by workers maintaining employment in the face of declining demand, or by managers simply stealing profitable assets. In most countries, governments had neither the interest nor the capacity in effect to renationalise. The only alternative to the gradual disappearance of the state's assets, probably into the hands of the former communist <u>nomenklatura</u>, was thought to be rapid privatisation.

There was also a political logic to speedy privatisation. For the first time in more than a generation, people in Central and Eastern Europe were faced with the prospect of dismissal and unemployment, and this at a time when living standards were falling sharply. For reform momentum to be maintained many politicians believed they had also to create a significant group of winners from reform. One way was rapidly to create a new class of owners through the privatisation of former state assets.

Given the experience of communist rule, the population in many countries also put little faith in the views of the state as an independent agent, acting to maximise social welfare. More cynical interpretations of public ownership were prevalent, with the dangers of rent seeking and corruption from continued state ownership being stressed (see eg. Frydman and Rapacynski (1994), Boycko, Schleifer and Vishny (1996)). This powerful urge to "depoliticise" the enterprise sector was for many observers the most significant motivate for speedy and widescale privatisation.

3. <u>PRIVATISATION METHODS</u>

Methods of privatisation have not been a major issue in Western economies; some form of auction method has typically been used. But public offerings across the whole of Central and Eastern Europe as a way to privatise the bulk of the economy faced insurmountable problems. The stock of private savings is far too small quickly to purchase the assets of the industrial sector at prices which would reflect future expected profitability. For example, it was calculated that at pre-reform savings rates it would take more than a century for the government to sell the assets of the Czechoslovak industrial sector, even if valued at their historic cost.

This does not rule out the use of auction or public tender methods in the sale of a few selected firms. The most likely customers are foreign multinationals, though the idea of selling the viable parts of the industrial sector to foreigners has given rise to considerable disquiet throughout the region. The policy has however been applied with some success in Estonia and Hungary. Some governments have also favoured the purchase of firms by their managers and workers, sometimes with ownership rights concentrated on Trusts. Such management-employee buyouts (MEBOs) have been significant in Poland and Romania.

An alternative privatisation method for transition governments has been restitution to former owners. This immediately recreates a property owning middle class, and re-establishes "real owners". However it is highly regressive, leading to instantaneous concentrations of wealth in the hands whose sole claim to such privilege is the circumstances of their parents or grandparents. It is also very slow because for example, suppose that a factory has been built on a plot of land formerly owned by a farmer. Does he receive the land? Or should he be compensated for the value of the property at the time of its seizure? How are such valuations made? Nonetheless, restitution has been an important element in privatisation in several Central European countries.

In most transition countries however, policy makers concluded that conventional privatisation methods could not deliver the required scale of privatisation in the relevant time frame. They therefore innovated a new method of privatisation; "mass privatisation". This involves placing into private hands through vouchers the "savings" that would be required to purchase state assets.

Mass privatisation avoids the problems of enterprise valuation. Most importantly, it allows large numbers of firm to be sold speedily, while in principle permitting an egalitarian distribution of the former government assets. However, governments forego most if not all potential revenues from privatisation.

In the following section, we analyse mass privatisation schemes in more detail and categorize the variety of schemes used across the region. In section 5, we report on the combinations of privatisation methods - restitution, MEBO, mass privatisation and so forth - used in different countries. We also consider the consequences for ownership arrangements, post-privatisation.

4. <u>A Taxonomy of Mass Privatisations</u>

In this section, we categorise mass privatisation schemes according to legal structures and privatisation methods. The material is summarized in Table 1 which provides information on the 18 countries which have introduced mass privatisation schemes. The most conspicuous absentee is Hungary, but also none of the former Yugoslav economies are included except Slovenia. In the former Soviet Union, Azerbaijan, Turkmenistan and Uzbekistan have not introduced a mass privatization programme.

The table reports the year that voucher distribution began and provides information about three aspects of the design of such schemes:

i. The form in which the vouchers are issued. There are two questions here - should they be bearer or registered, and should they be tradeable. (Bearer shares are always tradeable). Behind this is the issue of who receives the vouchers. Equity suggests that they should be distributed to the entire population, but in some of the newer countries created by the disintegration of the former Soviet Union, questions of nationality, ethnicity, and seniority have also been relevant.

ii. How should firms be sold? The shares could be br[illegible] market continuously, as firms become ready, or [illegible] involving the simultaneous offer of 25% or [illegible] companies eligible for privatisation. The latter approach allows buyers to compare alternative options but is administratively much more demanding. In the ambitious Czech and Slovak scheme for example, shares in enterprises were transferred in waves comprising hundreds of firms simultaneously. A computerised system was set up to mimic a general equilibrium market clearing process.

iii. What kind of capital institutions should be build into the process? Mass privatisation transfers ownership rights but leaves the character of future capital markets open. In some schemes, capital market intermediaries are an integral part of the programme; in others they are allowed or actively encouraged. In the Czech and Slovak republics and Russia, the vouchers could be exchanged directly for shares in companies. Financial intermediaries though only encouraged by the end of the process controlled a majority of shares in Czechoslovakia. Investment funds also emerged spontaneously in Russia, though their shareholdings are more modest. In the Polish scheme, citizens' vouchers were exchanged for shares in government created Investment Funds that jointly own all the former state owned enterprises. From these characteristics in Table 1, we can discern two broad forms of mass privatisation. Russia and Belarus used a market in which shares were continuously issued, vouchers were bearer and funds were encouraged. Armenia, Georgia and the Kyguzk Republic used the same approach, except that funds were allowed rather than encouraged. The three

Baltic states, Slovenia and Ukraine were the same as Armenia except that vouchers were non-tradeable. In contrast, Bulgaria, Moldova and Romania followed the Czech-Slovak model with shares issued in waves, non-tradeable vouchers and funds encouraged. The Polish variant of this model, also followed by Khazakstan and Romania (1992), differed in that Investment Funds were compulsory.

5. Ownership Structures in Central and Eastern Europe

In this section, we examine the evidence on the ownership arrangements resulting from privatisation in Central and Eastern Europe. We focus on the share of the new private sector in output as well as the new owners of former state property.

The World Bank Development Report (1996) provides evidence as on the extent of privatisation across all transitional economies. The shares of the private sector in GDP are reported for 26 countries in transition. The share already exceeds 50% in ten countries, and exceeds 33% in eighteen countries. The private sector share of GDP was highest in the Czech Republic(around 70%) and lowest in Belarus (around 10%). Though studies (see eg. Estrin (1994), Nuti (1995), Frydman, Gray, Rapaczynski (1996) stress that it has proved harder than expected to privatise some large scale state enterprises, the pace of privatisation has been remarkable by Western standards.

We noted above that most transition countries have used a variety of privatisation methods. The situation is summarised for six leading transition countries in Table 2. Only in Estonia and Hungary have sales to outsider owners represented significance privatisation methods, and both of these countries have relied disproportionately on foreign direct investment to finance their privatization strategies (see Estrin, Hughes and Todd(1997)). Elsewhere, mass privatisation or buyouts by managers and workers[1] have predominated.

The relatively high share of output supplied by the private sector appears to be largely independent of the privatisation method adopted, or indeed of whether any sustained policy has been enacted at all. Thus, Poland, Hungary, the Czech Republic and Russia all have private sectors supplying more than 50% of output. However, Hungary did not have a mass privatisation policy; the Polish programme has been modest in comparison with other privatisation methods (see Gomulka (1994)), and as noted above the Russian and Czech schemes represent opposing modes of mass privatisation. An important reason is that much private sector growth everywhere has been via small scale privatisation of shops, farms and workshops, as well as via de novo growth of the small industrial enterprise sector. Some argue that the growth of the new private sector is at least as significant for the emerging market systems of Eastern Europe as the pace of privatisation of the large state owned industrial giants (see

1 Russia's mass privatisation fell somewhere in between: - it enabled many managers and workers to buy the enterprises in which they were employed

Schaffer and Richter (1996)).

One can classify the ownership arrangements resulting from privatization as follows: -

i. insider owned or outsider owned, where "ownership" is defined as a controlling interest in the firm.

ii. Among insider owned firms, we can distinguish between manager owned and worker owned firms.

iii. Among outsider owned firms, we can highlight some key categories, notably foreign owned firms (FO) and firms owned by Investment Funds (IFO).

Earle and Estrin (1995) used data on five countries to categorise firms by dominant owner. They found that a majority of private firms were insider owned in Poland, Romania and Russia, as well as a majority of domestically owned private firms in Hungary. Only in the Czech Republic, of this sample, had mass privatisation created outsider ownership and even here the effectiveness of governance arrangements have been widely questioned (see eg. Coffee (1996)). A particularly interesting case is Russia, which privatised extremely rapidly between 1992 and 1994. According to Commander et al's (1996) study, 83% of privatised firms were majority owned by insiders in 1994. Of these, workers held on a majority stake in 78%. The same study found that insiders' average holding of shares was around 66%, as against 20% for outsiders and 14% for the state. This had not changed greatly by 1996; Blasi (1997) reports the shares to be

65%, 20% and 13% respectively.

6. Conclusions

Privatisation in Central and Eastern Europe has complex and contradictory motives. The two main reasons have been to improve corporate efficiency and to "depoliticse" the enterprise sector through the rapid transfer of control from the state to private hand. This pressure for speed combined with a shortage of domestic savings and an immature capital market has led the transitional economies to innovate in methods of privatisation. Thus a variety of mass privatisation methods have been developed. These have contributed to a rapid growth in the share of private sector output and employment throughout the region, though progress has been slower among large firms in the industrial sector.

Company behaviour post-privatisation depends on more than whether a firm is state or privately owned; it also depends on who has become the new owner and the new governance structures. The discussion in section 2 presupposed that owners were outsiders to the firm, interesting in maximising the returns from their assets. A large literature attests that outcomes of privatisation are much less likely to be successful when the majority owners are insiders, either managers or workers [illegible] Earle and Estrin (1996), Aghion and Blanchard (1996), M[illegible] Schleifer and Vishny (1993)).

The problems parallel to those for the state as owner. For example, workers as owners may be concerned with objectives other than profits, most notably wages or employment. Processes for scrutinising managers will be particularly opaque in worker owned firms, and the transactions costs of making decisions may be high. Problems from employee ownership may be exacerbated in the transition context, where restructuring probably involves the reduction of employment.

We have seen that successful outsider ownership relies on efficient capital markets, so their immaturity in transitional economies is therefore clearly a problem. Moreover outsider ownership arrangements work less well when ownership is widely dispersed, because the costs of monitoring for each owner can outweigh private benefits accruing from the scrutiny. Employee ownership is typically highly dispersed, since most workers have at best very modest individual shareholdings, while Czech-type mass privatisation schemes, though ensuring outsider ownership, led to the bulk of the population each holding tiny parcels of shares.

For most countries, there has been a clear trade-off between speed and short-term effectiveness of privatisation, in terms of improved corporate governance. Sales of firms to outsiders have been rare, and as a consequence, revenues from privatisation have been almost everywhere very small as a share of the government budget.[2] Privatisation strategies have tended to rely on manager-employee buyouts, mass privatisation schemes or both, and have resulted in the predominance of insider ownership. At the same time, while capital market institutions are developing rapidly in many countries, the emergence of structures that could reliably enforce effective corporate governance has been slow (see EBRD, Transition Report, 1995).

It is much too early for a balanced judgement of the impact of privatisation on company performance in Central and Eastern Europe. Initial studies have found little evidence that privatised firms behave very differently to their state owned counterparts, though in the more advanced countries some more robust findings about the effects of privatisation are emerging (see eg. Brada (1996) for a survey). Key issues for the future will be whether outsiders begin to purchase shares from managers and workers, allowing evolution to a more conventional system of capital market scrutiny, and whether the new private sector, whether by internal growth or acquisition of former state owned firms, will eventually displace the privatised sector.

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2 Except in Hungary and the Czech Republic (where it exceeded 5% in some years).

1. Mass Privatisation Programmes in Central and Eastern Europe and the Commonwealth of Independent States

Country	Year voucher distribution began	Are shares issued in waves or continuously?	Are vouchers bearer, tradeable, or nontradeable?	Is investment in funds allowed, encouraged, or compulsory?
Albaina	1995	Continuously	Bearer	Encouraged[a]
Armenia	1994	Continuously	Bearer	Allowed[b]
Belarus	1995	Continuously	Bearer	Encouraged[c]
Bulgaria	1995	Waves	Nontradeable	Encouraged
Czech Republic	1992	Waves	Nontradeable	Encouraged
Estonia	1993	Continuously	Tradeable[d]	Allowed[e]
Georgia	1995	Continuously	Tradeable	Allowed[b]
Kazakstan	1994	Waves	Nontradeable	Compulsory
Kyrgys Republic	1994	Continuously	Bearer	Allowed[f]
Latvia	1994	Continuously	Tradeable	Allowed[e]
Lithuania	1993	Continuously	Nontradeable	Allowed[e]
Moldova	1994	Waves[g]	Nontradeable	Encouraged
Poland	1995	Waves	Tradeable	Compulsory
Romaniah	1992	Continuously	bearer	Compulsory[i]
Romania	1995	Waves	Nontradeable[j]	Allowed
Russia	1992	Continuously	Bearer	Encouraged
Slovak Republic	1992	Waves	Nontradeable	Encouraged
Slovenia	1994	Continuously	Nontradeable	Allowed
Ukraine	1995	Continuously	Nontradeable	Allowed

a. By July 1996 only one or two funds had applied to receive vouchers
b. Although a legal entitlement exists to invest vouchers in funds, in practice this option was limited.
c. The results of the first voucher auction were cancelled in March 1995, and fund licences were suspended from then until August 1996.
d. Vouchers were nontradable at the outset of the program, but cash trading was legalized in the spring of 1994.
e. Citizens could also exchange vouchers for other things such as apartments or land.
f. Citizens could invest their vouchers in housing as well as share. They can sell their vouchers to funds, but no formal mechanism exists for them to subscribe to funds.
g. Although the design of the Moldovan program was based on the offer of companies in waves, the waves were small in the early stages, and thus had many of the characteristics of a continuos issue
h. In 1991 Romania introduced a scheme based on the distribution of certificates of ownership in five private ownership funds In 1995 a supplementary mass privatisation programme was introduced involving the distribution of coupons that could be exchanged for company shares or fund shares, after which the funds are to be transformed into financial investment companies.
I. Under certain circumstances certificates of ownership in funds could be exchanged for company shares
j. Certificates of ownership were bearer, coupons were registered and nontradable.

Source: Estrin and Stone (1997)

Table 2. Methods of privatisation of medium sized and large enterprises, by value to end 1995.

	Sale to outsiders	Management-employee buyouts	Equal Access Vouchers	Restitution	Other	State owned
Czech Republic	5	-	50	2	3	40
Estonia	60	12	3	10	0	15
Hungary	40	2	0	4	12	42
Lithuania	<1	5	55	0	0	35
Poland (by number of firms)	3	14	6	0	23	54
Russia (by number)	0	55	11	0	0	34

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