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Framework Issues in the Privatization Strategies of the Czech Republic, Hungary, and Poland

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FRAMEWORK ISSUES IN THE PRIVATIZATION STRATEGIES
OF THE CZECH REPUBLIC, HUNGARY, AND POLAND

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ABSTRACT

Framework issues in privatization include the alternative of commercialization of state-owned enterprises without privatization, the scope and sequence of divestiture by branch of the economy, the organizational structure for privatization, the choice among standard and non-standard methods, and problems in the administration of privatization, such as valuation, transparency, and corruption. For each issue, the study analyzes major aspects and compares relevant experience of the Czech Republic, Hungary, and Poland.

JEL classifications: D73, H82, K42, L33, P21, P52.

Keywords: privatization, state-owned enterprises, corporatization, commercialization, divestiture, restitution, management and employee buyouts, mass privatization, valuation, transparency, corruption.

This study examines some issues that provide a framework for national privatization strategies. The first part considers the scope and sequence of privatization. The second part discusses the organizational structure for privatization, divestiture methods, and problems in the administration of privatization. For each of these dimensions of privatization, the study analyzes key aspects and compares the experience of the Czech Republic,[1] Hungary, and Poland -- countries which are leaders in privatization in Central Europe.[2] The conclusion draws some general lessons.

SCOPE AND SEQUENCE

In 1989 the private sector produced a small share of GDP in these three countries: less than 10 percent in Czechoslovakia, approximately 20 percent in Hungary, and about 25 percent in Poland (Borish and Noël, 1996, p. 33).

Thus, the potential scope for privatization -- through divestiture of state activities as well as from private startups -- was enormous. In regard to divestiture, key issues included (1) the advisability of "commercializing" state enterprises without privatizing them, and (2) to what extent, in what sequence, and at what speed divestiture should proceed in different branches of the economy.

Commercialization

It is important to distinguish three concepts of transformation of a state-owned enterprise (SOE). (1) "Corporatization creates a new separate legal entity for the firm by converting an SOE into a joint-stock company (JSC) all of whose shares are (initially) held by the State Treasury. (2) "Commercialization" implies that the new JSC, unlike the former SOE, will be run as a profit-seeking business. (3) "Privatization" entails divestiture of

(some of) the JSC's shares by one or a combination of various methods, such as initial public offerings (IPOs), public tenders, management and employee buyouts, and auctions of shares for vouchers distributed free under a mass privatization scheme.

"Corporatization" by itself clarifies property rights, now to be exercised by the government agency representing the state as shareholder in the JSC. Corporatization may regain for the state as shareholder some property rights previously ceded to, or usurped by, enterprise managers or workers. For example, in a JSC operating under commercial law, there is no provision for a workers' council with some authority over employment and compensation, selection of enterprise managers, and the firm's investment policy. Also, by expressing ownership in numerous separate JSC shares, corporatization facilitates privatization -- by disposal of blocks of shares -- when an enterprise is too large to be sold in its entirety to a single buyer.

Issues

In an economic reform, is it sufficient to commercialize a corporatized enterprise, without privatizing it?

Supporters of commercialization without privatization assert that a JSC (all of most of) whose shares are held by the State Treasury (or other agency representing the state) can operate efficiently if four sets of conditions are met (Pannier and Schiavo-Campo, 1996, pp. 14-24; World Bank, 1995, pp. 76-92). (1) The firm must have "hard budget constraints" -- both fiscal (no subsidies or tax preferences) and monetary (no preferential credit, such as lower interest rates, longer repayment periods, or automatic rollovers; and no exemption from bankruptcy procedures). (2) The firm must face rational ("scarcity") prices for inputs and outputs. (3) The firm must confront genuine

competition of domestic rivals (without barriers to entry) and imports (as a result of trade liberalization and currency convertibility). (4) The State Treasury must properly supervise the firm's management. This task includes (a) selection of qualified people (with appropriate training and experience); (b) specification of demanding but attainable targets for relevant performance indicators (profit, exports, investment projects); (c) provision of suitable incentives for good performance; and (d) removal of poorly performing managers.

Advocates of commercialization without privatization cite empirical studies of cases (including some without corporatization or formal commercialization) in which managers of state firms facing most, if not all, of the above conditions restructured their firms in four dimensions consistent with the pursuit of profit maximization (Carlin and others, 1995, pp. 430-442). (1) Managers altered the internal organization of the firm, for instance, by spinning off non-core activities. (2) They reduced employment and revised labor compensation to stimulate productivity. (3) They adjusted the product-mix and output volume. (4) They modernized plant and equipment.

Skeptics concerning commercialization without privatization doubt that the government will strictly enforce hard-budget constraints upon commercialized state firms. Even if explicit budget subsidies are not provided, the firms might get more favorable treatment from government banks or from private banks that expect the government will be the ultimate guarantor of a state firm. In addition, government officials seeking to maintain employment can encourage managers to retain unneeded workers, through the officials' acquiescence regarding the resulting higher labor costs and total costs, lower profits, and smaller dividends to the Treasury as shareholder (Shleifer and Vishny, 1994). Also, the government may retain some

barriers to entry protecting the state firm against competition from domestic and foreign rivals.

Critics observe that studies of (explicit or implicit) performance contracts for managers of state enterprise in market economies show that such contracts often have poor results regarding improvements in productivity and profit, for three reasons (World Bank, 1995, pp. 112-132). First, managers have better information than government officials about the enterprise and therefore can negotiate contract provisions favorable to the management (for instance, easier performance targets). Second, rewards, linked to flawed targets, are easily earned, whereas penalties are seldom applied. Third, the government fails to honor its commitments to managers, for example, to pay government bills to the firm and to fund government-mandated investments (such as for environmental protection).

Furthermore, without privatization the commercialized enterprise cannot get additional equity capital, needed for modernization and expansion, from domestic and foreign sources, as well as the benefits of foreign direct investment (FDI) in the transfer of technology and management skills and access to foreign markets.

Finally, critics note that successful restructuring of (even not yet corporatized) state enterprises was due in part to the management's expectation that the enterprise would be privatized. Thus, the management wanted to perform well, by making the firm (more) profitable, in order to participate in and benefit from future decisions about the form of privatization (Pinto, 1995, pp. 205-208).

However, among those who believe that commercialization is insufficient and must be followed by privatization, there is some disagreement about how soon the commercialized firm should be privatized. Proponents of a "slow"

approach think that it may take some years to prepare some enterprises for privatization, by first carrying out financial, organization, and/or physical restructuring.[3] Supporters of a "fast" approach consider it unwise to delay, and thus perhaps avoid, privatization. They think that most financial and organizational restructuring should occur before, or in connection with, privatization, but that physical restructuring should be left to the new private owners (Bornstein, 1992, pp. 310-311).

Country Experience

The Czech Republic, Hungary, and Poland differed considerably in regard to commercialization without privatization.

Czech Republic. In the Czech Republic commercialization without privatization was supported by some SOE managers and some government officials who wanted a very slow and thus selective privatization process. However, the government adopted a broad privatization program that divested a large amount of state property within a few years (Kotrba and Svejnar, 1994).

Hungary. In Hungary commercialization began before corporatization (and privatization). The "New Economic Mechanism" introduced in 1968 eliminated annual output assignments and allocations of material inputs for enterprises. Instead, the firm adjusted outputs and inputs in pursuit of profit, to which managerial and worker incentives were linked. Yet the firm operated in a highly regulated market, in which the state formally controlled significant aspects of investment and pricing and also intervened in various informal ways in enterprise activities. There were numerous forward and backward steps in the reform process, but ownership relations were not addressed directly until the 1980s (Révész, 1990).

Corporatization was part of a gradual and complex process of ownership change (Canning and Hare, 1994, pp. 182-185). The 1984 Enterprise Act gave SOEs with enterprise councils the right to set up joint ventures with state or private partners. The 1988 Company Act authorized these SOEs to form commercial companies. Some SOEs established companies for individual plants, and the SOE itself became a kind of holding company for these new companies. The 1989 Transformation Act provided for the conversion of the parent SOE itself into a JSC, with the state retaining only part of the shares. A portion of the equity was allocated to local governments, which exchanged their ownership of the enterprise's land for shares in the company. Up to 10 percent of the shares was bought at preferential prices by employees of the firm. Some shares were sold to other Hungarian companies, to Hungarian private individuals, and to foreign investors. The result was a combination of (1) corporatization, (2) partial privatization, and (3) extensive interenterprise ownership with an intricate web of vertical and horizontal links (Stark, 1996, pp. 1001-1007).

Poland. In contrast, the Polish controversy over the desirability of corporatization and commercialization without subsequent privatization has been more explicit and sustained (Poland, *Komercjalzacja*; Blaszczyk, 1995, pp. 81-83; Szomburg, 1995, pp. 82-85; interviews).

Advocates of this approach wanted to transform some, or many, SOEs into JSCs in which the State Treasury would replace branch ministries (or the Ministry of Privatization) as the state owner-controller. A supervisory board (with two-thirds of the members chosen by the government and one-third by the employees) would select and monitor the management; determine the allocation of profit and investment; and decide about sale or lease of the company's assets. These advocates believed that property rights in the enterprise would

be clarified, and "rationalization of management" could be accomplished without subsequent privatization. Although the workers' role in the control of the firm would be reduced by the elimination of the employees' council (standard in an SOE but not present in a JSC), workers could benefit from corporatization and commercialization in other respects. First, when the *popiwek* tax on excessive wage growth was in force during 1990-94, it applied only to SOEs, not to JSCs, whose workers could get greater wage increases than SOE workers. Second, job security could be enhanced if commercialization led to restructuring that strengthened the company's competitive position.

Opponents doubted that corporatization without privatization would help much. They asserted that empirical comparisons showed no significant differences in the behavior and performance of Treasury-held companies and traditional state enterprises (Karpinska-Mizielinska, 1994, pp. 146-147). They believed that only with privatization would firms get the infusion of financial, human, and physical capital necessary for restructuring.

The 1990 privatization program of the early post-Communist government regarded corporatization as a step to improve corporate governance during a short transition (up to two years) to privatization. In contrast, the coalition that came to power in 1993 favored mass commercialization without the presumption of privatization. In 1995 Parliament passed a law providing for corporatization without privatization, as well as for Parliamentary approval of the government's privatization decisions in selected branches, such as energy, banking, and telecommunications. President Walesa vetoed this legislation. After his defeat in the subsequent presidential election, Parliament passed a 1996 Law on the Commercialization and Privatization of State-Owned Enterprises with two significant features. On the one hand, it made corporatization easier by removing the previous stipulation that an SOE

could not be corporatized without the consent of the managers and employees.[4] On the other hand, the law included a provision that corporatization and commercialization could occur without subsequent privatization. However, the new government formed after the September 1997 elections has asserted its intention to privatize many of the remaining state enterprises (EBRD, 1997, p. 189).

Thus, the three countries had different approaches to corporatization, commercialization, and privatization. The Czech Republic corporatized SOEs in order to privatize them. Hungary commercialized SOEs before corporatizing them, and the extent and pace of the companies' subsequent privatization were uneven. Poland was slower to corporatize SOEs over the opposition of managers and workers, and more willing to consider commercialization of the corporatized entities without the final step of privatization.

Branch Differences in Divestiture of State Assets

Comprehensive reliable comparative data for a definitive assessment of the extent, sequence, and speed of privatization in the three countries are lacking.[5] Yet it is possible to suggest a prototypical pattern and to identify some differences of individual nations from it.

One might expect a phased, differentiated, and incomplete divestiture of state assets, rather than a comprehensive and speedy "big bang" approach, for both economic and political reasons (Roland, 1994). Among the economic factors were (1) the large amount of assets to be divested, (2) the characteristics of particular branches, (3) the financial conditions and market prospects of individual firms, and (4) the interest and absorptive capacity of potential buyers. Political considerations included, for instance, (1) perceptions that certain "strategic" branches should remain entirely or mostly in state hands,

(2) opposition to sales of some parts of "the national patrimony" to foreign investors, and (3) fears that post-privatization restructuring would cut employment.[6]

Branch Characteristics

By way of illustration, Table 1 identifies some characteristics affecting the scope and sequence of divestiture in selected branches of the economy. With this framework it is possible to group branches into several categories according to the ease, and thus the scope and sequence, of divestiture of SOEs. Such a classification helps one understand fundamental features of the privatization process. However, because of particular initial conditions and subsequent policies (de Melo and others, 1997), privatization experience in a specific country inevitably varies in some respects from any prototypical pattern.

Category 1: Comprehensive divestiture intended and relatively easily achieved. This category includes, for example, retail trade, consumer services, and housing. Before national privatization programs began, these branches already had significant private activity -- some of it informal (in the "underground economy"). Relatively small capital investment was required to buy state assets, and to restructure enterprises' equipment, employment, and output. Foreign investment was not crucial, the activities were not deemed "strategic" on economic or military grounds, and no special regulatory framework was needed.

Retail trade and consumer services (including shops, repair establishments, and laundry and dry cleaning facilities) were especially appropriate for divestiture of state assets (Earle and others, 1994). There already was some private ownership and entrepreneurship -- openly or in

"second economy" activities. Also, there was wide popular support for privatization through divestiture of state assets and new private startups, in the belief that the quantity, variety, and quality of goods and services would increase.[7] Horizontally-integrated trusts of shops could relatively easily be broken up for divestiture of individual establishments, or sets of enterprises could be sold as small chains. Finally, privatization of retail trade and consumer services supported a government's political objective of creating a "middle class" of owners of small businesses.

In the case of *housing* (Clapham, 1997), many separate dwellings and some apartments were already privately-owned, because they were excluded from nationalization after World War II or were subsequently built privately as individual structures or as units in cooperatively-held buildings. By divestiture, the government could shed the burden on the budget of subsidies to state-owned housing operated at a loss with low, even nominal, rents. Obvious candidates to acquire state housing were the present occupants. They had some de facto property rights of tenancy, they expected rent increases under price liberalization programs, and they could be helped to buy their units through below-market prices and generous long-term credit. Yet the privatization of state housing was delayed somewhat until the resolution of various issues. One was the extent of the discount from market value to be given to current tenants. Another was the reorganization of cooperative housing with limited property rights into full-fledged condominium private ownership. The third was arrangements for management of common areas in buildings with separately-owned units.

Category 2: Extensive divestiture desired, but more difficult. Agriculture and light industry are examples of branches in this group.

In the three countries, state farms constituted a relatively small part of *agriculture*, often with a highly specialized role such as experimental or breeding facilities. Most farmers worked on agricultural cooperatives or individual farms. Thus, privatization could entail divestiture of state farms' property or reorganization of cooperatives to transfer land, buildings, equipment, and animals to individual farm families (Euroconsult Center, 1995). However, major changes in land tenure were restrained by two factors. One was farmers' satisfaction with and thus preference for, cooperatives' arrangements, such as steady work at regular wages. Another factor was farmers' reluctance to face individually the risks associated with the weather and with the restructuring of agriculture under economic reforms. The changes included the reduction of budget and credit subsidies to agriculture; less favorable relative prices of agricultural inputs and outputs; and, as a result of trade liberalization, greater competition from more efficient West European producers.

With currency convertibility and the reduction of import restrictions in these countries, *light industry* (including food and tobacco products) also faced new competition from foreign goods of superior quality. Enterprises in this branch required new investment to carry out product and process innovations and cost reduction. In many cases, FDI had a critical role in providing new capital, production technology, and management.

Category 3: Only partial or gradual divestiture sought. Branches in this group -- such as heavy industry, banking, and infrastructure activities -- need substantial restructuring and thus FDI to infuse new capital, technology, and management. However, because they may be deemed "strategic" on economic or military grounds, there may be opposition to divestiture, particularly if it

involves FDI. Also, banking and "natural monopolies" in infrastructure require special regulatory regimes.

In parts of *heavy industry* -- such as mining, metallurgy, and machine building -- many enterprises are hard to divest because they operate at a low profitability or losses for various reasons. On the one hand, they have difficulty selling output on domestic or foreign markets because of an outdated mix of low-quality products. On the other, their costs are high because of obsolete equipment and excess labor. Their divestiture and successful private operation entail considerable financial, organization, and physical restructuring. In some instances, the scale of the enterprise requires a large capital investment, involving FDI. When these giants dominate their respective "company towns," there is considerable political resistance to reorganizations that cut employment and enterprise-provided health, child care, and recreational services.

Divestiture of state-owned commercial *banks* (SOCBs) has been slow for several reasons (Anderson and Kegels, 1998, pp. 74-257; Bonin and others, 1998, pp. 19-56). When these banks were spun off from the pre-reform "monobank," they inherited portfolios of bad loans, which in turn were linked to inter-enterprise indebtedness. Before the SOCBs could be even partially privatized, their asset portfolios had to be strengthened by the government's guarantee of (part of) the banks' bad loans, or the government's assumption of these loans in exchange for government bonds (in a process labeled "reconciliation" or "consolidation"). Banks had to be recapitalized with the injection of new funds.

As "strategic" or "core" investors, foreign banks potentially could play an important role in restructuring SOCBs, by providing new capital and introducing new information and payment systems, methods of loan evaluation,

and banking products and services. However, there was political opposition to FDI in banking through the acquisition of shares in domestic banks or the entry of foreign banks as independent rivals.

Also, the new central bank created from part of the old monobank had to learn how to use such instruments as reserve requirements and rediscount rates to control indirectly (rather than directly through plan assignments as in the pre-reform regime) the creation of credit and money by commercial banking. Similarly, the central bank must learn how to perform supervision of independent commercial banks in regard to loan quality, liquidity ratios, capital standards, auditing of financial statements, and other aspects of "prudential" operation. Until the elements of this special regulatory framework are mastered, the government may want to retain majority or significant minority ownership in individual banks as a way of exerting direct internal influence on bank operations.

Hence, divestiture of state-owned shares in commercial banks has been limited so far, and specific banks have been privatized to different degrees, by different methods, and with different types of new owners.

Privatization in *infrastructure branches* -- such as electricity, telecommunications, natural gas pipelines, and water supply -- has been restrained for various reasons. Large capital investments are required to modernize and extend the networks. FDI is necessary not only to help finance these investments but also to introduce new technology (such as cellular telephony) and better management that can improve the quality of service and reduce operating costs (Carter, Sader, and Holtedahl, 1996). Thus, any political opposition to foreign involvement in these "strategic" branches must be overcome.

Privatization of infrastructure branches involves more than simple divestiture of existing monopolies to private owners. Rather, privatization should be based on a complex and time-consuming analysis of existing and potential market structures, the extent to which competition can and should be introduced (nationally and in particular geographic markets), and the costs and benefits of demonopolization (Guislain, 1997, pp. 203-286). In electricity, "unbundling" of the state monopoly can separate generation, transmission, and distribution, instituting competition in the first and third stages (Newbery, 1994). In telephones, different degrees of competition can be initiated for the several types of wired service (local, domestic long-distance, and international) and cellular service (Armstrong and Vickers, 1996). In both electricity and telecommunications special provisions must be made for rivals' access to an established operator's physical network facilities (such as power transmission lines or local telephone lines). Also, the government must decide the speed with which competition starts, including the advisability and length of a transition period of temporary exclusivity to furnish incentives for the first private firm.

In regard to the mode of privatization, the government must choose among (combinations of) (1) permanent transfer of ownership of existing assets, (2) concessions which limit the duration of the asset transfer, and (3) new entry. In all three cases, the government seeks experienced operators with a proven successful record in the branch. In the first two instances, the government frequently aims initially to place a controlling (though often minority) block of shares with such a strategic investor, selected by competitive bidding or direct negotiation. Later, after the investor has begun to improve the enterprise's performance, the government offers a second tranche of shares to the general public for dispersed passive shareholding. In recognition of the

branch's "strategic" nature, the government may retain a "golden share" with the right to veto mergers or takeovers, the transfer of certain assets, or the closing of particular facilities.

The lengthy preparation for privatization in these infrastructure branches also includes elaboration of a post-privatization regulatory framework. It tries to reconcile such objectives as (1) satisfaction of demand, by adequate investment, with good service and reasonable rates; (2) efficiency of operation and adequate return for the operator; and (3) protection of rivals competing with a dominant producer.

One critical element in the framework is the choice of "rate of return" or "price cap" as the rate (tariff) regime.[8] Another is the administration of regulation, which has three important facets. (1) Which level of government (national, regional, or local) should be responsible for regulation? (2) Should a single agency regulate multiple branches, or should each branch (electricity, telecommunications, and so forth) have its own regulator? (3) How can the regulatory bodies be insulated from political pressures? This complex regulatory framework must be fully articulated and made known before privatization bidding (or negotiation) starts, and it must effectively be in place before or at privatization.

Category 4: Little if any divestiture envisioned; virtually complete state ownership to continue indefinitely. Branches in this category include railroads, ports, and munitions. They are deemed too strategic for divestiture. They may have large capital requirements for physical restructuring. Also, private investors have little interest in a branch such as railroad transportation which operates at a loss covered by a budget subsidy.

Country Experience

The Czech Republic, Hungary, and Poland generally conformed to the stylized sequence just analyzed. Space constraints preclude detailed accounts of each country's divestiture activity in each of the branches in Table 1.[9] Instead, the following discussion presents some available data about the overall result of the privatization effort in each country and some examples of continuing state ownership.

Czech Republic. The non-state sector's contribution to Czech GDP was almost 75 percent in 1997. Yet in many "privatized" companies, the state remains a minority shareholder. Also, the state is an indirect investor in many other firms through the banking system. The state retained a blocking minority interest in some leading commercial banks which sponsor investment trusts that hold shares in operating companies and banks (Desai, 1996). Furthermore, the state holds controlling interests in 53 "strategic" enterprises in iron and steel, coal mining, gas and energy distribution, and telecommunications (EBRD, 1997, p. 164).

Hungary. The private sector generated about 75 percent of Hungarian GDP in 1997. The privatization program has encompassed numerous manufacturing enterprises, all major banks, and a significant portion of infrastructure activities. Hungary has been a leader in Central Europe in the privatization and deregulation of telecommunications, for example (Guislain, 1997, pp. 237-238). However, the unprofitability of some large SOEs in iron and steel, chemicals, machinery, and other parts of heavy industry has impeded their privatization. Also, the state has retained a majority stake in the national electricity company and minority ownership, with a golden share, in some of the largest companies and banks.[10]

Poland. The share of the private sector in GDP reached 65 percent in 1996. Privatization in Polish heavy industry, especially coal mining and machine building, has been hampered by the unprofitability of many enterprises and fears that restructuring, before or after privatization, will entail dismissal of workers. The pace of bank privatization has been slower than initially envisioned. Only four of nine commercial banks spun off from the National Bank of Poland and one former specialized bank were privatized by 1997. In the case of one bank, the government rejected two bids and cancelled the tender. In an effort to facilitate privatization, the government has consolidated some smaller banks into a larger, more viable institution (EBRD, 1997, p. 191). Much of Polish agriculture was decollectivized in 1956. Thus in 1989 family farms already had 72 percent of the agricultural land, compared with 24 percent in state farms and 4 percent in cooperatives. Hence, the main thrust of agricultural privatization has been the leasing of state land to family farmers. But this process has been retarded by the weak financial position of these farmers, who typically operate small tracts with outdated technology and inefficient marketing channels (Pyrgies, 1995).

Thus, by 1997 the private sector contributed about two-thirds of GDP in Poland and three-fourths of GDP in the Czech Republic and Hungary. The three countries generally conformed to a common sequence of privatization of individual branches, corresponding to the difficulties various characteristics posed for privatization in particular branches (see Table 1). However, each country had its own special features in the treatment of individual branches.

ADMINISTRATION

Three main elements in the administration of privatization are the organizational structure, the methods used, and performance problems in the privatization process.

Organizational Structure

This section examines some of the major organizational issues and how the three countries handled them.

Issues

The chief issues regarding the organization structure of privatization involve the degree of centralization or decentralization in the distribution of decision making across four dimensions.

Government or enterprise. In a "top-down" approach, a government agency decides and carries out the privatization of an SOE. In a "bottom-up" approach, the management, perhaps subject to the consent of the employees, decides to privatize the SOE and conducts the process. In a combination of the two approaches, the government determines that the SOE should be privatized, the SOE proposes the method of privatization, the government approves or modifies the proposal, and the government (or possibly the SOE) handles the privatization.[11]

National or local government. Municipalities or other local or regional authorities are often responsible for some privatization operations, typically those affecting municipal enterprises or other small businesses. The central government may make the decision to privatize that class of firms, with the local authorities carrying out the actual divestiture.

Executive, legislative, or judicial branch within the national government. Although the executive branch is primarily responsible for the design and implementation of privatization, the legislature may play an important role in several respects. The parliament will establish the legal framework for small-scale and large-scale privatization and for mass privatization by vouchers (coupons). However, it may also require parliamentary approval of annual (or multi-year) privatization programs. Furthermore, the parliament may impose constraints on the privatization of specific branches or individual enterprises. And it can even challenge, by inquiries and threats of no-confidence votes, particular privatization actions of the government.

Privatization legislation in Central European countries does not usually include judicial review of administrative decisions (Nestor, 1993, pp. 97-98). However, standard legal provisions against violation of contracts, fraud, and abuse of office apply to privatization transactions. Also, constitutional questions, such as unequal treatment of different classes of persons, might be pursued in court.

Agencies within the national government's executive branch. Responsibility for different functions may be distributed among several types of agencies. The *policy* function involves the basic design of the program and articulation of the main guidelines to implement it. The *divestiture* function entails the actual disposal of part or all of the state's stake in particular enterprises, by one or more methods. The third task is *representation* of the state's ownership interest in the firm -- before privatization, after partial privatization, and if no privatization is intended.

A single ministry of state property (or privatization) might be given all three roles. Or one privatization agency might be assigned the policy

function and a separate agency the divestiture and representation functions. Also, other bodies, such as branch ministries and the ministry of finance, might perform the representation function and share in policy and divestiture decisions affecting their particular jurisdictions.

Further, a competition agency might have some responsibility regarding divestiture, in addition to its major concerns about cartel-like behavior and abuse of a dominant position. For example, the agency might give "opinions" about whether specific SOEs with market power should be partitioned so that some plants and other units can be divested separately.

However, the greater the number of government bodies involved in the privatization process, the greater the risk of overlapping powers, conflicts of interest, and delays in reaching and carrying out privatization decisions.

Country Experience

The Czech Republic, Hungary, and Poland took different approaches to the organizational structure for privatization.

Czech Republic. The Czech Ministry of Privatization (MOP)[12] -- officially the Ministry for Administration of State Property and Its Privatization -- strongly dominated the process, although some other actors had significant roles (Drábek, 1993; Kotrba and Svejnar, 1994, pp. 148-149; Buchtíková, 1996, pp. 76-79; interviews).

Neither the parliament nor the judiciary was influential in Czech privatization. Local governments had a minor role in "small-scale" privatization of retail and consumer service establishments. Within rules set by the MOP, local authorities sold enterprises under their jurisdiction and assisted local units of the MOP in other sales.

In "large-scale" privatization, the MOP published a list of SOEs to be privatized, including a subset of them assigned to participation in voucher privatization. The management of each SOE prepared the "basic" privatization project for the firm, but alternative proposals could be submitted by prospective buyers. The branch ministry reviewed the proposals for firms in its sphere and forwarded them with its recommendation to the MOP for the final selection. In this procedure the SOE and the branch ministry had considerable influence. Management projects had two advantages over outsider projects. First, management had more detailed information about the enterprise. Second, management could mislead and discourage outsiders, for example by providing them incomplete or inaccurate data about the firm's production capabilities and financial condition. Thus, in the first "wave" of privatization, ending in 1992, 82 percent of the approved projects were submitted by SOE managements. The branch ministry's power came from three sources. (1) It appointed the SOE managers. (2) It could revise their proposals before submitting them to the MOP. (3) The number of enterprises to be privatized was so large that the MOP could not evaluate all of the proposals it received and instead usually accepted the branch ministry's recommendation.[13]

The Ministry of Economic Competition (MEC) was supposed to review the market power implications of each privatization project selected by the MOP. However, because the thousands of projects far outstripped the MEC's modest resources, the MEC routinely accepted virtually all of the MOP's decisions (Zemplinerová and Stíbal, 1995, pp. 253-254; Fingleton and others, 1996, p. 155).

After final approval of a privatization project, ownership of the SOE was transferred to the National Property Fund (NPF) to carry out the divestiture envisioned in the project. The NPF also took over from the branch

ministry the representation function, exercising property rights over unsold assets and JSC shares temporarily or permanently held by the state.

In 1996, after most of the privatization program was accomplished, the MOP was abolished and supervision of the NPF was assigned to the Ministry of Finance.

Hungary. The organizational structure for Hungarian privatization was characterized by frequent changes and division of responsibility among many bodies.

The balance between centralization and decentralization in decisions about privatization was altered several times (Voszka, 1993a; Voszka, 1993b; Voszka, 1994; Major, 1994; UN, ECE, *Economic Survey of Europe in 1993-1994*, pp. 185-198; Henderson and others, 1995, pp. 88-102; Ludányi, 1996; interviews).

In "spontaneous privatization" during 1988-1990, managers of some large SOEs reorganized their firms by setting up JSCs on the basis of individual factories or establishments. The central unit legally preserved its SOE status by acted as a holding company. Some shares in the JSCs were placed with (state-owned) banks, other state enterprises, and local governments. In some cases, SOE assets were contributed to joint ventures with foreign investors. This procedure was spontaneous in that SOEs initiated and carried out the transformation. Yet they did so within the existing legal framework and with the knowledge and approval of supervising government agencies. However, the process did not involve privatization, insofar as the state remained the owner of the SOE center, and of the shares in the JSCs held by the SOE center and other state units. Nevertheless, there was some decentralization of power and property rights from the ministries to the SOEs, and from the latter to the new JSCs.

It was widely thought that spontaneous privatization gave SOE managers opportunities to transfer state assets in ways that enriched themselves, and sometimes foreign investors, at the expense of the state treasury (Fletcher, 1995, pp. 30-34). In response, the State Property Agency (SPA) was created in 1990 to centralize the privatization process in two ways. On the one hand, the SPA was to supervise the transfer of state property by SOEs through sale or lease of assets or the spin-off of units into JSCs. SOEs were required to seek the SPA's consent for such transactions above a low monetary threshold. However, the SPA routinely approved SOE proposals, rather than effectively controlling the process. On the other hand, the SPA itself was supposed to divest firms, particularly through three "programs" to privatize selected large SOEs. But the SPA succeeded in selling only four of the twenty firms in the first set, and it therefore made no attempt to dispose of the second and third sets.

Conceding that it lacked the staff and information to "take command of privatization," the SPA turned in 1991-1992 to the decentralized approach of "self-privatization" of small and medium-sized firms. The SPA designated 80 consulting firms as "privatization advisors." From this list, an SOE could choose an adviser to prepare and carry out a privatization project, under SPA guidelines. The advisers were deemed to represent both the SPA and the firm. The SPA exerted more authority under self-privatization than under spontaneous privatization. The SOE considered self-privatization faster and more flexible than privatization conducted by the SPA itself. However, consultants found it difficult to satisfy two masters -- the SPA and the SOE. In 1993 the SPA decided to terminate self-privatization and handle divestiture of firms itself.

The SPA's scope was sharply reduced in 1992 by the creation of the Hungarian State Holding Company (HSHC), to whose jurisdiction enterprises with about 40 percent of the book value of state assets were transferred. The HSHC's portfolio comprised companies in steel, machinery, chemicals, pharmaceuticals, telecommunications, oil, and transportation, and included 160 large SOEs. The HSHC was to restructure some of these firms so they could eventually be (at least partly) privatized. However, about half of the HSHC's assets were to remain indefinitely in state hands, because the government then in power believed that effective conduct of economic policy required direct and long-term involvement of the state in "economically strategic" branches. The SPA, in contrast, was left with jurisdiction over small and medium-sized SOEs, which it was supposed to privatize.[14]

This division of responsibility was relatively short-lived. Following 1994 elections in which the center-right bloc lost control of the parliament to a socialist-liberal coalition, new legislation combined the SPA and HSHC into a single Hungarian Privatization and State Holding Company (HPSHC). After the merger was completed in 1995, the HPSHC had about 90 percent of the value of state shares in firms. One justification for the consolidation of the two organizations was that it could speed privatization. Another argument was that with the desired reduction in the number of companies in which the state would hold permanent ownership stakes, it was not necessary to have two separate organizations with different forms of management rights. The HPSHC was set up as a public company like the HSHC, rather than as a government agency like the SPA. One reason was the belief that a corporate legal form could facilitate privatization of firms in weak condition through the write-off of their debts to the state -- an action not permitted if a state agency owned the

enterprises. Another reason was that the HPSHC staff could be paid higher salaries than civil servants.

Branch ministries have been significant in the Hungarian privatization process. At various times the head of the privatization effort held sub-cabinet rank, and was subordinate to the Minister of Finance or the Minister of Industry and Trade. Branch ministries -- rather than the SPA, HSHC, or HPSHC -- formally exercised the state's ownership rights in designated firms.[15] In other cases, branch ministries exerted considerable influence over the operation of, and privatization measures for, companies in the portfolios of the privatization bodies. Finally, the Ministry of Finance had special responsibilities in the privatization of banks.

The Office of Economic Competition (OEC) had a formal voice in the (few) divestiture decisions involving mergers that would increase concentration, rather than only maintain current concentration. Although the OEC could comment on other divestiture cases, privatization decisions, especially about sales to foreign investors, were not usually constrained by considerations of competition policy (Vissi, 1993, pp. 213-25; Fingleton and others, 1996, pp. 155-156; Török, 1996, pp. 38-42).

Local governments had relatively minor roles in Hungarian privatization. They could decide on the sale of real estate, shops, and other establishments they owned. On the basis of the value of the land occupied by an enterprise, the local government received some of the shares in a corporatized firm or part of the proceeds from its sale. Also, the local government itself could buy an SOE (Hungary, SPA, 1993, p. 133).

In contrast, the Hungarian parliament has been very important in privatization. As noted, when parliamentary elections transferred control of

the legislature and thus the executive branch from one coalition to another, major changes in the institutions and policies of privatization followed.

The most striking judicial action affecting Hungarian privatization was the Constitutional Court's rejection -- on grounds of unequal treatment of different types of claims -- of key features of restitution legislation concerning the time of expropriation, the type of assets, and the form of redress (Comisso, 1995).

Poland. The administration of Polish privatization was largely, but not entirely, centralized in the Ministry of Privatization (MOP), which exercised the policy, divestiture, and representation functions in most branches (Filipowicz, 1993; interviews). However, the respective branch ministries controlled privatization of enterprises in, for example, mining, energy, agriculture, and foreign trade, and the Ministry of Finance handled the privatization of banks. In other branches, the supervising ministry was consulted by the MOP about privatization actions, especially those affecting large firms. Yet, until 1996 an SOE could not be corporatized without the consent of its management and employees.[16]

The Anti-Monopoly Office (AMO) was notified of all proposed actions involving the corporatization or divestiture of SOEs. It rejected a very small number of proposals outright, and in some cases made conditional decisions approving transformation if the firm were divided into smaller units to be privatized separately. The AMO had a cautious stance toward partition, on the ground that it was difficult to find the correct balance between the gain from a more competitive market structure and the loss of economies of scale and scope.[17] In the divestiture process competition aspects were usually subordinated to the MOP's desire for higher revenue from sale prices reflecting continued market power, and for investment and employment

commitments by buyers (Fornalczyk, 1993, p. 37; Fornalczyk, 1995; Slay, 1996, pp. 136-138).

Local governments could privatize enterprises -- usually in retail trade and consumer services -- in which they had ownership rights. The firms typically were privatized by sale or lease of all or part of the enterprise.

The Polish parliament asserted its power over privatization in various ways. It established the institutions, such as the MOP; it determined the conditions for corporatization of SOEs; and it authorized the different methods of privatization. Parliamentary bodies scrutinized and sometimes challenged MOP decisions in specific cases.

The judiciary's most important action concerning privatization occurred in 1995 when the Constitutional Tribunal upheld President Walesa's veto of a parliamentary bill on commercialization and privatization. The court ruled that the bill's limits on executive branch authority violated the constitutional distribution of powers between the legislative and executive branches.

In 1996, after the start of the mass privatization program, the MOP was abolished in a broad program of decentralization of government administration. A new Ministry of the Treasury (MOT) was created to exercise the policy, divestiture, and representation functions for the state's share in partly privatized JSCs scheduled for further privatization, as well as the representation function for about 200 larger SOEs not designated for privatization. A new Privatization Agency, under the MOT, handles small-scale privatization activities. Finally, the ownership of about 1,200 SOEs was transferred to local governments.

Table 2 compares some key aspects of the decisionmaking structure of privatization in the three countries. In the executive branch of the national

government, authority was most sharply delineated in the Czech Republic, with the MOP responsible for policy and the NPF for divestiture and representation. Hungary underwent successive administrative reorganizations that reflected uncertainty about privatization strategy. In Poland branch ministries shared the three functions with the MOP. Parliament and the judiciary were important in privatization in Hungary and Poland. Local governments played relatively minor parts in all three countries. However, enterprises had different roles in the privatization process in the these nations.

Methods

This section contrasts alternative methods of privatization and compares the three countries' experience with non-standard methods.

Issues

The main issues concern the extent to which a country should use "non-standard," as well as "standard," methods in divestiture of state property.

Standard methods. The major standard methods include (1) auctions of assets of small SOEs, (2) competitive bidding in tenders for SOE assets or shares in JSCs formed by corporatization of SOEs, (3) negotiated ("trade") sales of SOE assets or JSC shares to strategic investors, and (4) public flotation of JSC shares, for instance, through an initial public offering (IPO). Such methods are considered standard because they have been widely used in many parts of the world. The specific techniques involved, and their advantages and disadvantages for sellers and buyers, are well known. Thus, experience in other countries may help predict the outcome of divestiture actions and post-privatization performance of firms (Berg and Berg, 1997).

Non-standard methods. Such non-standard divestiture methods as restitution, management and employee buyouts (MEBOs), and mass privatization (MP) may supplement standard methods, for political and economic reasons. Restitution offers some redress for past injustice by the state. SOE managers who object to competitive or negotiated sales of their enterprises to outsiders may, however, agree to, or seek, privatization through MEBOs. Also, in the case of unprofitable enterprises that cannot be sold to outsiders, an MEBO may be the only alternative to closure of the firm.

MP involves free transfer to (adult) citizens of some state property, such as shares in JSCs or in investment trusts holding JSC shares. In this context "mass" refers to the universal and uniform opportunity for citizens to acquire property divested under MP. The term does not imply that all or most of state assets will be privatized by MP. MP can gain popular support for a privatization program because it gives each person free an individual part of previously collectively-owned property. Also, it may be impossible to privatize a large amount of state assets without MP. The funds available to potential domestic (individual and institutional buyers) will be small relative to the amount of property to be divested in a broad privatization effort in the transition from socialism to capitalism. Foreign investors will be interested in only some of the property designated for divestiture, and there may be political opposition to the sale of "strategic" assets to foreigners.

Country Experience

The Czech Republic, Hungary, and Poland all employed various standard methods of divestiture. However, they took very different approaches toward

non-standard methods (Bornstein, 1997). Therefore, the following discussion focuses on their use of the three major non-standard methods.

Restitution. The Czech Republic had the most effective restitution program. The government strongly preferred "physical" restitution through the return of the same property that was confiscated. The authorities feared that if restitution were made instead in cash or coupons for voucher auctions, the property would go mainly to members of the former Communist *nomenklatura* with funds to buy it (in cash or coupons acquired for cash). Restitution covered real property expropriated by the Communist regime after 1948. It thus excluded Jewish property seized by the Nazis after 1938, firms nationalized by the democratically-elected government during 1945-1948, and property of the Sudeten Germans expelled in 1945-1946. It is estimated that 10-25 percent of all state-owned apartment housing and retail shops was privatized by restitution.

In contrast, Hungary's restitution program involved financial compensation for real property confiscated after 1939 by the fascist, pre-Communist, and Communist regimes. Compensation was paid in freely tradable certificates that could be used to buy selected state property offered for these certificates. However, the government failed to provide enough assets for purchase by these certificates, because it preferred instead to sell property for cash and to strategic (rather than small) investors.

Poland has no restitution program, because of disagreements among political factions about the desirability and possible contours of restitution.

Management and employee buyouts. In the Czech Republic MEBOs were not specifically mentioned in privatization legislation and in practice were of negligible importance.

On the other hand, Hungary encouraged employee buyouts (EBOs), which actually were MEBOs, as a way of speeding the privatization of smaller SOEs in a "democratic" way through closed tenders. Although management usually held only about a fourth of the shares, it typically controlled the new firm. Though politically attractive, such buyouts often proved financially unviable because of the burden of debt inquired to acquire the firm. These buyouts have played a minor role in Hungarian privatization.

In Poland MEBOs were created under lease-purchase arrangements authorized by 1990 legislation providing that the state could "liquidate" a solvent SOE by leasing, selling, or otherwise "contributing" its assets to a new company. Although its assets remain and its operations continue, the enterprise's legal status changes from an SOE to a private firm. These MEBOs accounted for a significant part of the number of SOEs privatized, but a much smaller share of the revenue from privatization. As in Hungary, management controls the firm, and acquisition debt weakens financial viability.

Mass privatization. In the Czech Republic about 40 percent of the book value of property in the Large Enterprise Privatization Program was divested through MP. For a nominal fee, each adult citizen could buy a book of coupons with "investment points" to bid in auctions of state shares in JSCs formed from SOEs. In these auctions, the state set and adjusted the prices (in investment points) and the buyers bid the quantities (of shares) they wanted at those prices -- the reverse of the usual auction procedure in which the seller specifies the quantity and the buyer the price. Private investment funds (IFs) were not included in the original MP plan of the government, which expected that voucher privatization would lead to dispersed individual ownership of JSC shares divested by these auctions. Therefore, it was a surprise, not the intentional result of clever design, that about 450 IFs

emerged to collect approximately two-thirds of the voucher points. Moreover, the largest IFs acquired enough shares in particular JSCs that they could, individually or jointly, play an important role in the corporate governance of the firms.

Hungary adopted a weak version of MP called the Small Investors' Share Ownership Program (SISOP). Adult citizens were offered interest-free five-year loans to buy special SISOP shares in IPOs of SOEs to be privatized. The SISOP shares would constitute only 5-15 percent of the total IPO, with the bulk of the shares going to strategic investors who would control the firm. Although an experimental first round of two IPOs with SISOP participation was successful, after the June 1994 parliamentary elections the new ruling coalition abandoned SISOP.

In Poland MP involved the free transfer to the population of shares in 15 investment trusts called National Investment Funds (NIFs). Sixty percent of the shares in each of over 500 operating companies (OCs) was allocated to the NIF program; 15 percent was given free to employees; and 25 percent was retained by the state. In a lottery, a controlling 33 percent of the shares in each OC was assigned to a "lead" NIF and 27 percent was distributed among the other 14 NIFs. The lead NIF exercises corporate governance over the OCs which it controls, can restructure them, and can sell its shares in them. Non-lead NIFs usually disposed of their small positions in OCs. For a nominal sum, each adult citizen could get initially one master share certificate (MSC) representing proportional ownership in all the NIFs. Subsequently, the MSC could be exchanged for one separate share in each of the 15 NIFs. Both the MSC and NIF shares may be freely traded.

The three countries' MP schemes thus differed in major respects. MP was important in the Czech Republic and Poland, but not in Hungary. The Czech

Republic and Poland gave free claims to state property, whereas Hungary offered only favorable credit. Citizens had some portfolio choice in the Czech Republic and Hungary, but not in Poland. In the Czech Republic and Poland (though not in Hungary) investment trusts played significant, yet distinct, roles in the distribution of property and in corporate governance.

Table 3 summarizes the three countries' use of non-standard methods of privatization.

Performance Problems

This section analyzes some important issues in the conduct of privatization and examines relevant country experience.

Issues

The main problems concern the privatization agency's resources and how it handles divestiture transactions.

Resources. Successful administration of a privatization program depends on the quantity and quality of the people in charge of its preparation, implementation, and oversight; their incentives to perform well; and constraints against conflicts of interest (Guislain, 1997, pp. 173-175). A privatization agency's staff members must often make proposals with far-reaching repercussions, negotiate with powerful and experienced prospective foreign buyers, take decisions involving large sums, and perform other duties of a commercial rather than administrative nature. Also, the staff of a privatization agency should be able to coordinate and monitor the activities of other organizations involved in divestiture, such as branch ministries, local governments, and nongovernmental consultants. An effective incentive system should encourage the personnel of a privatization agency and other

organizations to perform their tasks in accordance with the interests of the state and the objectives of the government, for example the designated combination of speed, revenue, and suitable new owners. Finally, privatization laws and regulations should limit conflicts of interest. For instance, the personnel of government bodies involved in divestiture should be forbidden to buy enterprises or JSC shares offered for sale (except for ordinary participation as citizens in mass privatization). Further, individuals involved in privatization decisions, especially in buyer selection, should not be permitted to accept employment with any of the bidders for a specified period.

It may be difficult to find suitable people for the staff of a privatization agency in transition economy. There will be comparatively few nationals with appropriate qualifications and experience, because there was little role for privatization activities in the predecessor socialist centrally planned economy. Also, some of the ablest potential personnel for a privatization agency may prefer instead more remunerative positions and more promising career opportunities with prospective buyers, banks, or consulting firms.

Many governments with major privatization programs have used outside economic, financial, and legal advisers in formulating the overall privatization strategy, preparing enterprises for privatization, defining techniques and procedures for divestiture, and negotiating transactions (Guislain, 1997, pp. 190-197).

Because, especially at the beginning of privatization, transition economies do not have enough nationals with the required expertise, recourse to foreign advisers is often necessary. Usually there is a two-step selection process: (1) certification of a relatively short list of firms with

appropriate qualifications, and (2) participation by those firms in a formal tender process for particular assignments in the privatization program.

Yet there are potential difficulties with foreign advisers. First, lacking sufficient knowledge of local conditions, an adviser may propose measures which are unsuitable in the particular country, even though they were adopted elsewhere, perhaps at the adviser's recommendation. Second, foreign advisers' fees -- whether law firms' time charges or investment bankers' fixed fees or success fees (a percentage of the selling price) -- may seem excessive by national standards. Third, conflicts of interest may occur, for example if the adviser also works for multinational corporations that are potential purchasers of property designated for divestiture, or also consults for other governments that would compete for the same buyers by offering the same kind of assets, such as telephone companies, at about the same time.

Transactions. Major problems in specific divestiture transactions concern (1) valuation of assets, (2) transparency in actions, and (3) corruption in decisions.

The *valuation* of assets for divestiture aims to set a starting price for auctions, a reservation price for tenders or negotiated sales, or an offering price for share issues.[18]

At the beginning of the transition from a socialist centrally planned economy, the value of SOEs is not well depicted in their financial statements. For example, balance sheets do not accurately present assets, liabilities, and book values. In general, both assets and liabilities were recorded at non-scarcity prices. Land was not valued properly, if at all, because it was not traded. Plant and equipment may be shown at historical cost, or inadequately depreciated according to excessively conservative schedules. Furthermore, economic reform affects enterprise income statements and balance sheets in

many hard-to-predict ways. For instance, revenues change as output levels and mixes are adjusted in response to decontrol of prices, macroeconomic stabilization measures altering aggregate demand, and the liberalization of foreign trade. Costs are affected by different prices for material inputs, reduction of restrictions on employment and wages, and new environmental protection regulations. Reforms of subsidies and taxes modify before-tax and after-tax profits.

In these circumstances, historical book values are not reliable for the valuation of SOEs. Instead, privatization agencies (with the help of foreign advisers such as international accounting firms) may use various other methods (Birch, 1993; Hervé, 1993). (1) The price-earnings method relates estimated future earnings to the estimated future price-earnings ratio in that industry, perhaps based on experience in other countries, with an adjustment for country risk. (2) The discounted cash-flow method values the firm at the present value of prospective cash flows, by applying to these flows a discount factor (usually the weighted cost of equity and debt capital), plus a country-risk adjustment. (3) The market-entry method estimates the costs of establishing a new company to obtain the market share offered in the divestiture. The costs considered include capital investment, training, and possibly operating losses until the target market share is achieved.

All of these methods are arbitrary, involving assumptions and estimates of questionable reliability. The several methods are likely to yield different results. And their valuations may be below the historical book value of the divestiture offering -- with the risk that critics will charge that state assets ("the national patrimony") are being sold too cheaply. Ultimately, the "true" value of the assets will depend on what buyers are willing to pay at the time of the transaction.[19]

A divestiture action may be considered *transparent* when certain conditions are met: (1) The principles and criteria for decisions are announced in advance, and followed. (2) All prospective buyers have equal access to information about the assets offered. (3) After the sale, the purchase price is disclosed, with an explanation whenever the winning buyer pays less than the highest bid. (4) The buyer's compliance with purchase terms (such as timely payment) is enforced. Such transparency is desirable for fairness to prospective purchasers, maximization of revenue from divestiture, and public confidence in, and acceptance of, the privatization effort.[20]

Among the standard methods of privatization, public auctions, competitive bidding in public tenders, and public floatation of shares are more transparent than direct negotiations (usually conducted in secret with one prospective purchaser). Of the non-standard methods, restitution and mass privatization are more transparent than an MEBO (entailing a closed tender from a pre-selected buyer).

Corruption involves the abuse of official power for private gain, through misappropriation of state property or bribes for favors in its disposition. Corruption was common in socialist centrally planned economies with administrative allocation of goods and services and widespread shortages. Many officials and bureaucrats used their positions to personal advantage, obtaining special perks or monetary bribes. The privatization process offers new opportunities for corruption in a transition economy, which typically lacks appropriate legislation about conflicts of interest, and even effective enforcement of prevailing laws and regulations.

Three key factors influence the extent of corruption in privatization (Kaufmann and Seigelbaum, 1997). (1) The wider the extent of administrative discretion in privatization decisions, the greater the possibilities for

corruption.[21] (2) The potential for corruption is stronger, the less transparent the privatization process in regard to disclosure about rules and procedures (and exceptions to them), valuation of assets, and divestiture actions taken. (3) The slower the pace of privatization, the more time to exercise non-transparent administrative discretion to arrange corrupt transactions.

Considering these three factors, one can rank divestiture methods by their potential for corruption. Cash auctions of assets and mass privatization are least vulnerable to corruption, because they are fast and transparent, with little administrative discretion (other than, as with all methods, decisions about which property to include). It can take a long time to prepare an IPO, yet the sale is usually straightforward. Public tenders are time-consuming, but administrative discretion is low and transparency is high if the prospective buyers present simple money bids. However, if their bids include different conditions for investment and employment, administrative discretion and non-transparency provide opportunities for corruption. Negotiated ("trade") sales and MEBOs are the methods most open to corruption because they entail extensive highly discretionary bargaining in secret with a single buyer.

Country Experience

All three countries had problems in staffing, valuation, transparency, and corruption in divestiture.

Czech Republic. Because the MOP and NPF did not have sufficient qualified staff for a broad and rapid privatization program, they delegated to enterprises some of the negotiations with buyers of state property. Also, the privatization agencies hired foreign consulting firms for a wide range of

assignments, including advice on basic privatization strategy, review of specific privatization projects, identification of potential foreign investors, and negotiations with them. However, the foreign consultants often lacked appropriate experience for their tasks, as well as familiarity with local conditions and the Czech language. There was a large turnover in foreign advisors, with a long and costly learning process. Foreign consultants' fees were considered high for the services furnished (Drábek, 1993, pp. 118, 122; interviews).

Assets divested to domestic buyers were usually valued at book value. When property was offered to foreign buyers, international accounting firms were hired to estimate market value by various methods (Langr, 1993, pp. 58-59).

The Czech privatization process was weak in many aspects of transparency. The MOP did not reveal the multiple criteria (and their relative weights) for its choice among competing privatization projects. The NPF lacked standard procedures for public tenders, and firm deadlines for decisions about them. Also, the NPF did not enforce buyers' obligations to pay as scheduled for assets obtained in tenders or direct sales ("The Number of Nonpayers, 1993; "The National Property Fund," 1993; OMRI, *Daily Digest*, no. 90, part 2, 10 May 1995; interviews).

Czech privatization was characterized by extensive corruption. There was excessive administrative discretion, because the legislative framework was too broad, stating only general principles and leaving key features to executive branch decrees and ad hoc bureaucratic decisions. In turn, conflict of interest laws and rules were vague and weak (Kettle, 1995). A striking instance of misappropriation occurred in 1991 (before the split of the Czech Republic and the Slovak Republic) when a Federal deputy prime minister bought

for a nominal price a wholesale book distributor with prime real estate in downtown Prague (Kotrba and Svejnar, 1994, p. 184). Though not accused of personal impropriety, the head of the NPF resigned in 1994 after disclosure of irregularities in the privatization of specific companies, such as the sale of shares to a buyer not included in the approved privatization project (Gomez, 1994). The director of the Center for Voucher Privatization was arrested in 1994 for taking a cash bribe to arrange the sale of shares in a dairy company (Kettle, 1995). Finally, in 1997 Prime Minister Vaclav Klaus resigned after revelations about favoritism to privatization bidders that contributed to his Civic Democratic Party. One case involved three firms which made donations through a fictitious company in the Virgin Islands. In another instance, the Czech winner of a tender for a large stake in a major steel works contributed under the names of a Hungarian dead for 13 years and a Mauritian who had never heard of the political party (Frank, 1997).

Hungary. The privatization agencies sought to overcome staffing problems by offering Hungarians salaries above those for civil servants; reliance on local consulting firms as advisors for "self-privatization" (discussed in an earlier section); and extensive use of foreign consultants. Because of the high cost of foreign personnel, they usually were funded by foreign aid programs, either directly by the assignment of their own experts or indirectly by payment for consultants chosen by the SPA. By providing this support, foreign governments and international agencies gained opportunities to influence the Hungarian privatization process (Hungary, SPA, 1993, p. 131).

Valuation has been a thorny issue in Hungarian privatization. In the absence of a comprehensive, integrated privatization program, divestiture consisted of piecemeal sales of individual firms, with bargaining over specific transactions.

Privatization agencies used two approaches to valuation (Kerekes, 1993, pp. 53-54). "Asset valuation" sought more reliable figures than balance sheet data. "Business valuation" estimated a price based on projected earnings. These methods produced different and flawed results. Problems in asset valuation included assets with no foreseeable use, intangible assets, and land never previously priced. Difficulties in business valuation comprised forecasting future earnings, choice of a discount rate to obtain a present value, and the treatment of inflation. Thus the privatization agency had great flexibility in reaching a reservation price for divestiture.

Furthermore, the value of assets declined because of delay. The Hungarian privatization effort considered sales revenue more important than speed, and the pace of divestiture was sluggish (Major, 1994, p. 134; interviews). (1) The SPA often sought a firm's book value, when it was well above its market value. (2) For several reasons, the SPA (and HSHC and HPSHC) usually tried to sell an entire company, even when possible buyers showed interest only in a portion of it. The SPA believed lower effort and transaction costs would be needed to sell the whole firm together than (some) parts of its separately. The SPA expected it could get more revenue for the whole firm than a part of it. The SPA also thought more employment could be protected if the firm were sold in its entirety. Finally, the company's management strongly preferred disposal of the firm as a unit. (3) Even after potential buyers were found, the SPA was slow to conduct negotiations.

During the delay, the value of the company declined. On the one hand, the economy underwent a recession following the loss of markets in the former Soviet Union and Eastern Europe after the collapse of the Council for Mutual Economic Assistance's trading arrangements. On the other hand, Hungary, an early starter in privatization, faced increasing competition by other Central

and East European countries offering similar assets to foreign investors. Also, even when a firm's market value remained unchanged in Hungarian currency, its market value in real terms fell by 20-30 percent annually because of inflation and the depreciation of the forint (Mihályi, 1994, p. 379). In these circumstances, privatization agencies were sensitive to criticisms by opposition politicians and the media that they were selling property too cheaply, especially to foreign investors.

Much of Hungarian privatization has lacked transparency (OECD, *Hungary*, 1995, p. 114; OECD, *Hungary*, 1997, p. 58; interviews). Many tenders involved noncommensurable bids of different amounts with distinct business plans promising dissimilar combinations of employment and investment commitments. For an individual tender the privatization agency often could not furnish a plausible explanation for the choice of one proposal over another, or the rejection of all of them. Also, some approved deals had secret clauses with concessions for the buyer -- for instance, a reduction in the buyer's obligation to assume the Budapest Bank's bad loans (Pope, 1996). Furthermore, high-level political intervention occurred in specific privatization transactions. For example, in 1995 the prime minister revoked the SPA's acceptance of a 51 percent stake in 15 hotels of the HungarHotel Chain for US$ 57.5 million and a US$ 19.5 million investment commitment. The head of the SPA was dismissed, and a new tender for 14 of the hotels was issued with a minimum price of US$ 67 million and an investment commitment of US$ 24 million (*Wall Street Journal*, "Hungary," 1995).

In turn, wide administrative discretion, non-transparency, and delay led to extensive corruption in Hungarian privatization, as a few cases illustrate. In 1992 the first director of the HSHC was forced to resign after disclosure that, in addition to his annual official Hungarian salary equivalent to US$

12,000, he was receiving an estimated US$ 100,000-150,000 from a "technical assistance" account of the Hungarian-American Enterprise Fund, a U.S. Government-sponsored investment fund (Mihályi, 1994, p. 375). In 1996 the head of the HPSHC was sacked after it sold, over the objections of the SOE's management and the local government, a 51 percent stake in an oil-drilling company to a Russian firm established only after the HPSHC extended the deadline for tender bids (OMRI, *Daily Digest*, no. 106, part 2, 31 May 1996). In 1997 the head of the HPSHC and the cabinet minister supervising him were both dismissed following revelations that a consultant, hired to negotiate for the HPSHC with local governments over the division of revenue from property sales involving municipally-owned land, had given most of her fee of HUF 804 million (US$ 5.2 million) to the Socialist Party's electoral campaign fund.

Poland. The MOP suffered from frequent reorganizations, as the government and the privatization head were replaced when the ruling coalition changed after parliamentary elections. For instance, during 1990-1993 there were four different ministers of privatization, each of whom established a new organizational structure and appointed new people to the top posts (Jermakowicz, 1993, p. 119). The MOP staff was small relative to its policy, divestiture, and representation responsibilities, and turnover was high. The MOP frequently employed young and/or poorly qualified people who received their training on the job. After a year or two learning privatization techniques, many left the MOP for much higher-paying positions with private firms (Laier, 1995, pp. 310-311). Foreign consultants were widely used, but they often did not have the necessary qualifications; prepared unduly optimistic restructuring projects, business plans, and market analyses; and received fees deemed too high for the work done. Also, there were conflicts of

interest when consultants did appraisals of Polish enterprises later sold to foreign clients of the consultants (Mazur and others, 1994, p. 205).

The MOP was supposed to estimate the value of an enterprise for privatization by comparing the results from at least two of four methods: book value, liquidation value, replacement value, and discounted cash flow techniques. However, each method had its shortcomings, such as historical costs for book value, guesswork about liquidation value, uncertainty about which assets should not be replaced, and estimation of future cash flows and appropriate discount factors. Because the four methods usually yielded very different valuations, the MOP staff had great discretion in choosing a divestiture price (Jermakowicz and Jermakowicz, 1993, pp. 42-45).

Another source of administrative discretion -- and thus lack of transparency -- was the absence of standardized procedures. For instance, each trade sale of property was considered by the respective MOP project manager as an individual transaction to be handled in its own way. Even sales contracts were not standardized, but instead designed case-by-case in a time-consuming process (Laier, 1995, pp. 311-312).

The Polish press has reported relatively minor instances of corruption in privatization, such as privileged access to shares of good companies being divested (Kaminski, 1997). However, Poland has not had major scandals, involving dismissal of top privatization officials, comparable to the cases in the Czech Republic and Hungary.

As Table 4 indicates, the three countries experienced similar problems with privatization agencies' national staffs and foreign consultants. Valuation methods differed across the nations, but the multiplicity of methods contributed to extensive administrative discretion that made transparency of

the privatization process weak in all three countries. Yet corruption in divestiture was more serious in the Czech Republic and Hungary than in Poland.

CONCLUSION

The theoretical analysis and empirical comparisons of this study yield some general lessons.

(1) After corporatization, SOEs should be privatized, not merely commercialized. On the one hand, true commercialization of an SOE is doubtful, because the SOE will probably receive some preferential treatment by the government. On the other, privatization is much more likely to bring additional equity capital, new technology, and better management.

(2) The ease, and thus the scope and sequence, of divestiture can ordinarily be explained by branch characteristics, such as the amount of capital investment required, the extent of restructuring needed, the importance of FDI, and the requisite regulatory framework.

(3) A single privatization agency should formulate privatization policy, handle (or at least supervise) divestiture, and represent the state's ownership interest in firms to be divested.

(4) In the privatization of companies with dominant market positions, where it is possible without the loss of great economies of scale, they should be divided into component units for separate divestiture. Longer-term benefits of a more competitive market structure should not be sacrificed for higher revenue from sale prices that reflect market power.

(5) In the transformation from a socialist centrally planned economy to a capitalist market economy, mass privatization is necessary for extensive and fast divestiture of state property.

(6) In transition economies privatization agencies commonly lack adequate staff and must use outside consultants, whose performance is often unsatisfactory.

(7) Since valuation of state assets to be divested is difficult for many reasons, various arbitrary methods will be used to set starting or reservation prices, which may not be obtained from buyers.

(8) Transparency in divestiture decisions often is weak, with little disclosure of criteria, unequal access to information, and insufficient justification of decisions.

(9) Privatization provides many opportunities for corruption, because of broad administrative discretion, non-transparency, and disregard for conflicts of interest.

Table 1

Branch Characteristics Affecting Scope and Sequence of Divestiture of State Assets

	Characteristic					
Branch	Already partly private	Small capital investment required	Substantial restructuring needed	Foreign direct investment crucial	Possibly deemed strategic	Special regulatory framework essential
Retail trade	x	x				
Consumer services	x	x				
Housing	x	x				
Agriculture	x	x	x			
Light industry			x	x		
Heavy industry			x	x	x	
Banking			x	x	x	x
Electricity			x	x	x	x
Telecommunications			x	x	x	x

Note: An "x" in a cell denotes that the characteristic significantly influences the divestiture of state enterprises in the branch.

Table 2

Decisionmaking Structure of Privatization

Aspect	Czech Republic	Hungary	Poland
Policy function	MOP	SPA, HSHC, HPSHC	MOP, branch ministries
Divestiture function	NPF	SPA, HSHC, HPSHC	MOP, branch ministries
Representation function	NPF	SPA, HSHC, HPSHC, branch ministries	MOP, branch ministries
Parliament's importance	Nominal	Signficant	Significant
Judiciary's importance	Minor	Constitutional issues	Constitutional issues
Local government's importance	Minor	Minor	Minor
Enterprise's importance	Prepared basic privatization project	Sometimes carried out own privatization	Manager/ employee consent for SOE corpor-atization

Table 3

Non-Standard Privatization Methods

Method	Czech Republic	Hungary	Poland
Restitution	Return of physical property expropriated by Communist regime regime after 1948	Financial compensation for expropria- tions by fascist, pre-Communist, Communist regimes after 1939	No program approved
Management and employee buyouts	Negligible in absence of specific program	Nominally EBOs, actually MEBOs; minor role in privatization	MEBOs by lease- purchase; significant role in privatization
Mass privatization	Free vouchers to bid in auctions of OC shares; private IFs important; major program completed	Interest-free 5-year loans to buy IPO shares; weak program abandoned	Free share certificates in 15 NIFs, to which 60% of OC shares transferred; major program under way

Table 4

Performance Problems in Privatization

Aspect	Czech Republic	Hungary	Poland
National staff	Inadequate	Inadequate	Inadequate
Foreign consultants	Often unsatisfactory	Often unsatisfactory	Often unsatisfactory
Valuation methods	Domestic buyers - book value, foreign buyers - various methods	Asset valuation, business valuation by P/E	Book value, liquidation value, replacement value, DCF
Transparency	Weak	Weak	Weak
Corruption	Major	Major	Minor

NOTES

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1. On January 1, 1993, the former Czechoslovakia split into the Czech Republic and the Slovak Republic. This study considers privatization in Czechoslovakia before the split and in the Czech Republic afterwards. Since the split, privatization efforts have been much more modest in the Slovak Republic than in the Czech Republic.

2. For broad surveys of the national privatization programs, see, for example, Mejstrík (1997) on the Czech Republic, Ludányi (1996) on Hungary, and Blaszczyk (1996) on Poland.

3. Financial restructuring involves, for example, adjustment of assets on balance sheets from book value to market value and conversion of debt into equity. Organizational restructuring entails, for instance, division of a larger entity into smaller parts, such as the breakup of a trust composed of various enterprises, and the transfer to local government agencies of non-business activities like housing and health care. Physical restructuring includes upgrading or replacement of plant and equipment.

4. As a sweetener to offset the loss of this veto power, the law provided that employees of a corporatized firm could get 15 percent of its shares free and could buy additional shares in installments over five years.

5. For example, these data are not available in such likely sources as relevant publications of the Organization for Economic Cooperation and Development (*Trends and Policies in Privatization*), the European Bank for Reconstruction and Development (*Transition Report*), and the United Nations Economic Commission for Europe (*Economic Survey of Europe*). First, one would like data for various indicators of the private sector's share -- not merely in the number of firms or in GDP but also in assets and employment, both for the economy as a whole and by major branches. Second, international comparability requires a uniform definition of "private" (for example, private ownership of more than 50 percent of an enterprise). Third, official statistics should be adjusted for the common (and sometimes substantial) underreporting of private activity in the "informal," "shadow," "hidden," or "unofficial" economy to evade taxes and labor laws (Kaufmann and Kaliberda, 1996). Fourth, still more complex is the "privateness" of an enterprise which meets the adopted statistical definition (say, more than 50 percent privately-owned), but is subject to significant government control, for example by a state "golden share" with veto power over certain key decisions, or by government influence through subsidies and tax and credit preferences.

6. For a broad treatment of problems and constraints in the design and implementation of privatization policies, see Rondinelli and Iacono (1996), pp. 67-89.

7. A key component of divestiture was the conveyance of ownership or use rights in the real estate (buildings and land) where state firms were located,

because this transfer facilitated new startups on the premises of divested shops.

8. "Rate-of-return" regulation sets the overall rate level to achieve a target rate of return on an approved capital investment base. "Price-cap" regulation establishes a ceiling on the price increase for a specified basket of services for a designated period, for example at *RPI - X*, where *RPI* represents the inflation rate as measured by the retail price index and *X* is an allowance for the reduction in costs from expected productivity gains. An alternative version of the price-cap rule is *RPI + K*, where *K*, the allowable price increase above inflation, is supposed to reflect needed new capital investment minus the specified productivity improvement.

9. For examples of this approach, see Earle and others (1994) on retail trade and consumer services; Clapham and others (1997) on housing; Swinnen and others (1997) on agriculture; Anderson and Kegels (1998) and Bonin and others (1998) on banking; and Kontkiewicz-Chachulska (1997) on telecommunications.

10. Hungary's commitment to indefinite retention of a variety of state assets is illustrated by Parliamentary Act 49 of June 30, 1995. It specified for each of 174 companies a particular minimum state ownership stake -- of 25, 50, 75, or 100 percent, or one golden share. The firms are in numerous branches, including electric power, gas, telecommunications, electronics, agriculture, forestry, fishing, pharmaceuticals, banking, insurance, gambling, publishing, data processing, and air, rail, and bus transportation.

11. The ambiguous term "privatizing privatization" refers to the state privatization agency's use of a private consulting firm to design and carry out the privatization of one or more SOEs on behalf of the agency.

12. Until the former Czechoslovakia's split into the Czech Republic and the Slovak Republic on January 1, 1993, there were parallel administrative

structures for privatization for each republic, as well as a federal structure for federal property. However, because the amount of federal property was small, a department of the Federal Ministry of the Economy was the counterpart of the republic ministries of privatization.

13. For instance, during six months of 1992 the MOP approved 6,750 privatization projects (Bouin, 1993, pp. 126-127).

14. There are two much less important state asset management agencies. The Ministry of Finance's Treasury Asset Management Organization is responsible for privatization of real estate that belonged to the Hungarian Socialist Workers' Party and former Soviet military bases. Hunguest handles former trade union hotels and recreation facilities.

15. Branch ministries were designated to exercise the state's proprietary rights in 65 of the 174 companies listed in Parliamentary Act 49 of June 30, 1995.

16. The 1990 privatization legislation stipulated that the prime minister, upon the request of the MOP, could corporatize an SOE without the agreement of its management and employees. However, in practice it was not politically feasible to do so (Laier, 1995, p. 307).

17. However, as part of its regulation of mergers, the AMO sought to prevent (greater) concentration through the allocation of operating company shares to NIFs in the mass privatization program (discussed in a previous section). For each branch, the AMO prepared a list of companies whose "lead" shares, constituting a controlling 33 percent of total shares, could not be awarded to the same NIF, lest that NIF acquire a (more) dominant position in the branch.

18. Valuation for other purposes has different objectives (OECD, *Valuation*, 1993, pp. 110-111). Valuation for financial reporting seeks to give

an accurate picture of the enterprise's assets and their use over time. Valuation for tax purposes attempts to determine base values for depreciation for the profits tax and base values for the capital gains tax. Investors want valuations to find a risk-adjusted price that will allow them to achieve a desired rate of return.

19. In free transfer of assets, such as restitution of physical property or mass privatization, monetary valuation is initially avoided but occurs whenever the first recipient sells the assets.

20. However, most governments retain the right to reject tender bids without explanation. For example, a privatization agency may refuse a higher cash offer because it considers the bidder inexperienced or with a poor performance record elsewhere.

21. "Every point in the process of privatization that requires an official signature operates as a potential tollgate for corruption. When the decision to grant the signature is subjective and discretionary, it is easier for the official to justify delay and requests for further information -- the universal language for improper facilitating payments" (Kaufmann and Seigelbaum, 1997, p. 431).

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