THE PRIVATIZATION EXPERIENCE IN EASTERN EUROPE DURING TRANSITION TO THE WESTERN CAPITALIST SYSTEM

The Institute of Economics and Social Sciences
of
Bilkent University

By

ARDA AKARSU

In Partial Fulfillment of the Requirements for the Degree of
MASTER OF INTERNATIONAL RELATIONS

in

THE DEPARTMENT OF INTERNATIONAL RELATIONS
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ANKARA

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A Master's Thesis

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I certify that I have read this thesis and have found that it is fully adequate, in scope and in quality, as a thesis for the degree of Master of Arts in International Relations.

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ABSTRACT

Since the term "privatization" was given wide currency by the sale of British Telecom in 1984, many developing countries have launched privatization programs. The dimensions of the privatization revolution have been huge. The most profound change of all has been experienced in Eastern Europe after the fall of communism, which have adopted a variety of techniques to transfer ownership rapidly to private hands.

A very important key obstacle results from the legacy of communism: there was no existing private sector to buy the state-owned enterprises. In Western Europe and Latin America, , there has been a private sector capable of buying and managing state-owned enterprises, but this was not the case in Central and Eastern Europe. This meant that the economic and political leaders had to create their own mechanism to achieve privatization. Thus, to make a market economy out of the ruins of Communism faced an incredibly complicated task. They had to create a "private economy" where there was no pre-existing social group of "private owners".

The primary purpose of this thesis is the evaluation of the privatization experience of Eastern Europe in the post-communist period by showing the crucial interrelations between market reforms and democratic political reforms. The policies of post-communist governments –liberalization and privatization- were intended to allow "efficiency" considerations to shape organizations of the new capitalist economies.

ÖZET

Liberal anlayış çerçevesinde en geniş anlamda, devletin ekonomiye müdahalesinin asgari düzeye indirilmesi olarak izah edilebilecek olan özelleştirme, 1984 yılında British Telecom'un özelleştirilmesi sonrası gelişmekte olan ülkelerce benimsenmiştir. Boyutları çok geniş olarak gerçekleşen sözkonusu süreci, Komünizmin çöküşü sonrası Doğu Avrupa ülkeleri fazlasıyla benimsemiş ve devlet teşeküllerinin süratle özel sektöre devredilmesi için gerekli yöntemleri uygulamışlardır.

Kapitalizme geçiş sürecinde, özelleştirmenin önünde duran önemli engellerden bir tanesi, satılacak olan kuruluşları satın alabilecek bir özel sektörün bulunmaması idi. Özelleştirmeyi gerçekleştiren Batı Avrupa ve Latin Amerika ülkelerinde, devlet tarafından elden çıkarılmak istenen kuruluşları satın alabilecek ve sonrasında yönetecek kapasiteye sahip bir özel sektör bulunmaktaydı. Doğu Avrupa'da ise boyle bir durum mevzu bahis degildi. Bu da, ekonomik ve siyasi liderlerin yeni bazı mekanizmalar bularak özelleştirmeyi gerçekleştirmeleri anlamına geliyordu.

Bu tezin temel amacı, Doğu Avrupa ülkelerinde komünizmden kapitalizme geçiş sürecinde gerçekleştirilen özelleştirme deneyimini, piyasa ve demokratik reformalar arasındaki önemli ilişkiyi vurgulayarak incelemek ve konu hakkında genel bir değerlendirme yapmaktır.

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CONTENTS

Introduction

During the past eight years the states of Central and Eastern Europe have been struggling with a most daunting and unique task which is transforming a centralized economy into a market economy. In this transition from an economic system based on state ownership and centralized control of production and prices, privatization plays a key role. "Therefore, the stakes of getting the privatization process right are far higher than those faced by the states of Western Europe or Latin America.[1]

Why is privatization an important aspect of economic reform? In simple terms, privatization can improve economic performance and help promote domestic and foreign private investment—the lifeblood of reforming countries in the modern global economy. It also provides new economic opportunities for individuals, who can become investors or owners in former state-owned companies. In other words, privatization benefits the public and private sectors and consumers, not just the State Owned Enterprises (SOE)'s that are privatized.

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[1] D.Jeffrey Manners, "Looking at Privatization in Central and Eastern Europe", p.12

Privatization represents a potential revolution in the role of government in promoting economic growth and development—and in its role in society as a whole. This revolution, which has gained strength throughout since the 1980s, continues to gather momentum.

To understand just how important privatization programs have been as agents of economic change, consider the following key points:

- Less than ten years after the collapse of communism in Eastern Europe and the former Soviet Union, state ownership in former communist countries has been dramatically reduced. The state sector today represents less than half of the economies of Eastern Europe, and less than 30% of Russia's economy. Although the methods that have brought about this transformation have often been controversial, it is generally believed that privatization is now irreversible.
- Since 1988 over 70 countries have used direct asset sales as a method of divesting state-owned firms. These sales have raised over $175 billion through more than 800 individual transactions. The direct sale of SOEs to either foreign-owned investors or corporations brings the divesting government much-needed cash, and may often involve an injection of foreign technology and expertise.
- Since 1979 over 60 national governments have raised almost $500 billion through about 600 separate public sales of stock in SOEs. These share-issue privatizations have almost always been the largest share issues in a nation's history, and have often both radically

increased the number of individual shareholders and increased the liquidity and total capitalization of the nation's stock market.

The chief reason that governments increasingly choose to privatize SOEs is clear. Governments have been selling SOEs to private investors in order to improve these firms' performance through the discipline of private ownership, as well as to raise revenue without raising taxes. The specific objectives articulated for privatization programs are often very ambitious, and most tend to mirror the goals voiced by Margaret Thatcher's government during the early 1980s. These objectives are to: (1) raise new revenue for the state; (2) promote economic efficiency; (3) reduce government interference in the economy; (4) promote wider share-ownership; (5) provide the opportunity to introduce competition; and (6) develop the nation's capital markets.

Facing the economic consequences of their heavy reliance on state-owned enterprises, many developing countries have adopted new economic programs, featuring lower barriers to trade and foreign investment and other measures designed to promote competition and strengthen their private sectors. In Central Europe and the former Soviet Union, the collapse of socialism has likewise prompted fundamental transitions toward market economies based on private property and private-sector development. For both of these groups of countries, recent experience clearly demonstrates that privatization is closely linked to economic and political reform, and that it can serve as an important indicator of a government's commitment to reform.

Fundamentally, reformers in these countries recognize the importance of privatization in revamping their economic and industrial structures. Privatization both represents and embodies the economic revolution that they are attempting to bring about.

In this context, I will analyze the very important role of privatization during the transformation period in Eastern Europe. The main concern of this thesis is privatization in Eastern Europe and its role in the transition to a market economy in this region. I will try to emphasise the struggle in Eastern Europe to build capitalism on the ruins of communism. Within this framework the study aims to explain the impacts of privatization for their overriding goal of integrating with the western capitalist system.

Scope of the Study

This study consists of four chapters. In the First Chapter, a definition of the meaning of privatization will be given along with the role of privatization during the transition from socialism in Eastern Europe. In the Second Chapter, the general framework of privatization in Eastern Europe will be explained by emphasizing the problems of transformation of centrally planned economies into market economies and their social and political impacts. In the Third Chapter, there will be a case study to explain and specify the hypotheses. The impact of the privatization on the transition economies. Reflection on the promise of promoting economic growth. In the concluding chapter, a general evaluation of the East European case will be made in relation to some results

in the region and the situation today will be investigated. This will be followed by a conclusion to sum up the thesis

1. Privatization and Transition from Socialism to Capitalism in Eastern Europe

Privatization constitutes an important aspect of social, economic and political transformation in the late twentieth century. Over the last decade it has moved from being a little known technical term to a touchstone of economic development. The one-time unthinkable loss of state control over strategic assets such as transport and power has now become the norm, with a new consensus looking to the private sector for the efficient operation and investment of the infrastructure of the economy.[2]

In response to economic crisis, we see the renaissance of "laissez faire" ideology. In this context, privatization has become the main tool to reduce the role of the state in the economic domain, as a deep ideological movement toward decreasing the role of the government and increasing that of the private sector.

[2] The Official Publication of Turkish Prime Ministry, Privatization Administration, Privatization in Turkey, December 1999, p.2

The 1980s were the decade of debt crisis and capital shortage for many developing countries. The 1990s by contrast, have so far been a period of renewed private capital inflows. This boom in private investment has been the result of widespread macroeconomic stabilization and liberalization. Many developing countries want to improve their international competitiveness and are keen to provide a more attractive business climate for private economic activity. One particularly important component of this liberalization effort is a strong move toward reducing the size of the public sector.[3]

Most developing countries did not implement privatization as a tool of macroeconomic liberalization before the late 1980s. Since then however, privatization has grown strong in a rapidly expanding number of countries. This development has helped to create an attractive business environment in many developing countries and has intensified the interest of foreign investors.

Privatization has grown rapidly since 1988. At the same time, however there exist substantial differences among individual countries and regions regarding the intensity with which this policy has been pursued. This study shows that privatization can serve as an important tool for raising inflows of foreign investment into the developing economies of the countries. First of all, foreign investors participated directly in sizeable and easily accessible privatization programs. Additionally, well-run privatization programs also appear to have attracted additional investment flows abroad, independent of

[3] Henry Gibbon, Privatization International Yearbook 1996, p.13

the privatization program itself by advertising the country as an attractive investment location.

Privatization is a reduction in government ownership of the means of production. At the national level, to privatize an industry is to denationalize it, in contrast to nationalization, which is to bring the industry under government ownership. In post- World War II Britain, many industries (including steel, coal, mining, railroads) were nationalized by the Labor Party governments and several were denationalized later under the Conservatives.

The U.K. and the U.S.A have been the leaders of the privatization movement. In the U.K. the government's commitment to a private market philosophy has led to a series of proposals or decisions designed to replace the "welfare state" systems of collective provision and finance with more privatized systems since 1979. Privatization first gained prominence in the United Kingdom under the leadership of Mrs. Thatcher's conservative government. It has been notable both in scale and its high national and international profile.[4] Later on the trend toward privatization appeared to grow world-wide as the privatization policies were embraced as enthusiastically by the labor governments of Australia and New Zealand as they have been by some of conservative governments of Western Europe, as well as the Eastern European countries.

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[4] Ibid., p.23

Privatization, although initiated in the mature western economies, quickly spread to the developing world mainly under the driving force of the strong support from the international institutions like, The International Bank for Reconstruction and Development (IBRD) and International Monetary Fund (IMF). These institutions have induced many countries to reduce public expenditures and to adopt policies that would foster efficient use of the resources and bring about growth within the framework or stabilization policies. Thus, privatization and the reform of State Economic Enterprises (SEEs) have appeared to be new policy tools, which could be helpful in the realization of the above policies.

The term privatization was put into common usage by Robert Poole at the Reason Foundation in California, in 1976. Presidential aspirant Ronald Reagan soon began using the term in his radio broadcasts. In its purest form, privatization means selling off an entire government enterprise into unregulated private ownership. Some governments, however, sell off a minority stake in a government enterprise and call that privatization. It is common also to call the "contracting out" by the government for a service, such as trash removal, privatization. Contracting out allows the private ownership of resources, while government decides how the service is to be rendered, who will get, and perhaps also who will perform the service. Under contracting out, the service continues to be paid for by %50 tax revenues, rather than by user fees.

The main philosophy of privatization is to confine the role of state in the economy in areas like health, basic education, social security, national defence, large scale infrastructure investments; provide legal and structural environment for free enterprise to operate and thus to increase the productivity and the value added to the economy by ensuring more efficient organisation and management in the enterprises that should be commercialised to be competitive in the market.

The major targets of the privatization programs are primarily:[5]

- to minimize state involvement in the industrial and commercial activities of the economy,
- to provide legal and structural environment for free enterprises to operate,
- to decrease the financial burden of State Economic enterprises on the national budget,
- to transfer privatization revenues to the major infrastructure projects
- to expand and deepen the existing capital market by promoting wider share ownership,
- to provide efficient allocation of resources.

In the 1980s a strong worldwide governmental trend in favour of privatization developed. In many cases rhetoric far exceeded action, but a number of countries did sell off all or a substantial part of some government

[5] The Official Publication of Turkish Prime Ministry, Privatization Administration, op.cit, p.2

enterprises, and many services out to private firms. The British Prime Minister Margaret Thatcher's government, after its election in 1979, began to sell public holdings in several industries, including telecommunications. In the United States, the Reagan administration led an advocacy campaign, although state and local governments quietly took more action, mainly in the form of contracting out. Taxpayer revolts had early on reduced state and local government tax revenues, and the governments sought to reduce costs.

At the same time, airlines were sold by the Netherlands, Malaysia, Italy, and Thailand. Germany, Brazil, and Britain sold oil interests. The government of the Philippines sold hotels, sugar and coconut mills, and cement plants. Britain sold car and truck companies. The same events occurred in Spain. Chile sold banks and pension funds. And even the communist Cuban government sold housing to tenants.

Proponents of privatization argue that firms and assets owned by and operated in the private sector will generally be more efficient and more responsive to the needs of the public than those which are government owned and operated. They point out that effective political pressures often reflect much narrower interests than the public interest. For example, if an electric marketing company is publicly owned then customers will demand subsidized low rates, and politicians are likely to dip into the public treasury to deliver such favors.

At the managerial level, costs will be higher than in the private sector, since the discipline of competition and potential wealth loss by owners even the possibility of bankruptcy are missing. Without the opportunity to grow richer by finding and applying cheaper, more productive ways to deliver their goods and services, governmental managers have less incentive to be alert and tough in their efforts to operate efficiently. There is evidence that government enterprises exhibit these faults. Privatization would change the incentives facing owners and managers causing them to deliver more at a lower cost.[6]

On the other hand opponents of privatization point out that, privatization is no guarantee of improvement, and make specific situations worse. Politics and business are generally related, and if private monopoly is protected from competition by government or from losses by government subsidies or loans, then market discipline is missing. Corruption is always possible, and a private corrupt operation may be even harder to improve than if the firm were directly responsible politically, through government ownership. Private ownership alone guarantees very little. Freedom of entry and true financial accountability on the part of owners is necessary if private ownership is to be efficient. The opposite group also note that the move towards efficiency can itself be painful, since it may involve a reduction in jobs, a rise in previously subsidized prices, or a reduction in the availability of services when customers cannot or will not pay the full cost. Those who believe that government has a responsibility to subsidize housing, medical care, or

[6] John Sherrod, Privatization, p.74

schooling may favour only partial privatization as in contracting out. In the latter case, tax revenues finance all part of the consumer purchase from the private sector, and government retains some role in specifying the goods or services consumed.[7]

Governments have privatized to increase the size and dynamism of the private sector; to distribute ownership more widely to the population at large; to encourage and facilitate private sector investment, from both domestic and foreign sources, for modernization; to generate revenues for the state; to reduce the administrative burden on the state and to have a perfect free market model.The main requirements of a successful privatization program are the speed of implementation, social and political acceptability, establishment of working corporate governance arrangements, and the facilitation of access to foreign capital and expertise.

Another important advantage of privatization is transparency. This means, competitive bidding procedures, clear criteria for evaluating bids, disclosure of purchase price and buyer, well-defined institutional responsibilities, and adequate monitoring of the program.

The former communist countries adapted privatization very easily and rapidly. This is because, privatization in these countries has not been a simple

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[7] Frank Sader, Privatizing Public Enterprises and Foreign Investment, p.156

change of ownership but rather a complex social and political transformation.[8] Moreover, privatization in Eastern Europe is not just a goal for a market oriented economic reform. It is also a process to assist the transformation from communist structures to liberal democracies.

It has been said many times that the fall of communism in 1989 came to many as a big surprise. What was really surprising was not just the fall of communism but the relatively peaceful way that the communists gave up power in most of the Soviet Union and Eastern Europe. The tasks facing the region in order to create liberal democracies and market economies seemed enormous. Some people cautioned that the economic transformation will involve enormous social cost, for example Ralph Dehrendorf described it as crossing the "valley of tears". According to some social scientists, "the future of most of Eastern Europe is more likely to resemble Latin America than Western Europe".[9]

The first seven years of transition confirmed many of these initial fears and depressed predictions. The collapse of Yugoslavia and the bloody civil war that followed became symbols of the danger inherent in abandoning communist dictatorship. Economic transition proved to be a costly process. The liberalization of the region's economies resulted in growing unemployment, inflation, poverty and rising inequality.

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[8] Roman Frydman, Andrzej Rapaczynski, Privatization in Eastern Europe, p.11

Despite these obvious problems, the transformation unfolding in the region must be judged as surprisingly successful. New states emerged without civil wars. Democratic institutions have been introduced, lawfully elected parliaments and governments have gained power.[10] Political rights and liberties were expanded, free media emerged, and new civil societies developed rapidly.

Together with political life, state run economies were transformed. These countries introduced more comprehensive macro-economic stabilization reforms, liberalized the economy, and privatized a large part of state-owned assets. Most of the countries have renewed economic growth, reduced inflation, stabilized unemployment, rationalized fiscal policies, and secured foreign aid and investment. Especially in the Visegrad countries, economic transformations have been quite successful, regardless of continuing problems. In these countries, economic reforms are most advanced and liberal democracy is most secure.

The collapse of the Communist regime opened the way for the eager construction of a new system to be built on the pillars of political democracy, a market economy and an open society. Creating a market driven economy (and a political democracy) is not just about abandoning state regulations and controls and capacity for action, distributing shares in giant monopolies and running elections. It is first of all, about building institutions. And the core of the East European success is in institution building, especially the key

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[9] Ralph Dahrendorf, Reflection on the Revolution in Europe, p.56
[10] Grzegorz Eklert, Patterns of Postcommunist Transition in Eastern Europe, p.1

institution, a functioning state. The creation of stable and effective public administration is the key step toward the creation of a successful capitalist market system and a functioning democracy.[11]

Privatization – the process which transfers state-owned assets to private owners – has been the core policy of economic liberalization in Eastern Europe. Especially, western advisers presumed that private owners are at once the basis for a market economy and democracy and the main instrument to break the economic and political power of the state. The choices of the radical privatizers rested on a very particular theory of economy and politics in which the mere fact of private property would generate functioning markets and liberal politics.[12]

According to neo-liberals, privatization is the bridge from Communism to Capitalism. Two famous neo-liberals, Graham Allison and Grigory Yavlinsky, wrote in 1991,

'In economics, the core value of freedom is exercised in a market economy based on private ownership in which market forces of supply and demand answer the question of who produces what for whom...Ownership means the freedom to use and dispose of property as an individual chooses.

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[11] Stephen Cohen, Andrew Schwzrtz and John Zysman, The Tunnel at the End of the light: Privatization Business Development, and Economic Transformation in Russia, p.134

[12] Andrew Schwartz, The Best Laid Plan: The Unanticipated Evolution of Privatization in the Czech Republic, p.56

Basic laws of economics tolerate no equivocation on this point, none whatsoever.'[13]

The immediate neo-liberal objective of privatization is to create first private owners, not just private owners. This distinction stresses that the first private owners created by privatization are temporary owners; it is the last owners who will restructure companies and lead the move to democracy.

Market logic in a system of private ownership automatically will create the active private owners that enable free markets to produce prosperity and democracy. First private owners sell to intermediate private owners. Neo-liberals pay no attention to the market experience, skills, or attitudes of the first owners. They contend that the first owners, whoever they were, would be "economic" men, though they had lived under a state socialist system for decades. Neo-liberals only have disdain for first owners, such as workers, who would have obvious non-market incentives in a market economy.[14]

Moreover, a private ownership system presumably solves the transaction cost problem concerning the protection of private property and the lack of reliable market rules. First owners could only get the maximum prices for their assets if the active owners knew that property rights were secure, that is, if reliable rules were in place. Therefore, first owners have incentives to create and to enforce laws and procedures that protect property. In these

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[13] Garaham Allison and Grigory Yavlinsky, Window of Opportunity, Joint Program for Western Cooperation in the Soviet Transformation to Democracy and the Market Economy, p.3

[14] World Bank, Policy Recommendations on Banks, Capital Markets, and Enterprises Restructuring,, 1994, p.20

ways, a private ownership system establishes an efficient market economy and a modern democracy. Privatization's clear logic and clarity of purpose focused reformers on the task at hand, how to privatize.

The transition's political opportunities had offered the East European reformers a historic chance to privatize. They could act before privatization's likely opponents, who were momentarily disoriented by the Communist system collapse, could respond reformers risked a return to the Communist past or unthinkable move backward to the Third World by delaying privatization. The neo-liberal solution was then obvious, not just privatization, but rapid privatization.

Fundamentally, reformers in these countries recognize the importance of privatization for developing their economic and industrial structures. Privatization represents the economic revolution that they are trying to bring about.

The experiences of East Central European countries have been surprisingly positive, and their efforts to consolidate democracy, build market economies, and join the European political and economic structures look increasingly successful. Maybe the situation in the Balkans is not as promising. In these countries, the progress of political and economic transformation has been slower and less consistent. The policies of post communist governments have shifted more. Market reforms have been less advanced, privatization has slowed-down. In addition to that, their legal and

institutional infrastructure has been less developed and less transparent. Political rights and liberties have been less secure and the media are only partially free. However, the Central European countries – the Czech Republic, Hungary, Poland, and Slovenia – scored significantly higher in all indexes. Economic transformations in these countries are more advanced as the European Bank for Reconstruction and Development (EBRD) index of Transition Progress indicates. Their economies are more open and liberalized in comparison to other countries, economic policies are more stable and transparent, privatization has had a more consistent record, and large a private sector has emerged. And, the quality of democracy in these four countries is better as indicated by the Freedom House Index. Democratic institutions are not conflicted, political rights and liberties are more extensive and secure and the media are free. These countries are also better integrated economically and politically with the West and they are members of many multilateral organisations.

In most of the post-communist world, transformations so far have progressed in the direction of liberal democracy and an open market economy. The countries with the most advanced and successful economic transformations have at the same time the most secure and effective democratic systems. In more successful countries the level of approval of the new economic and political system is higher than in less successful countries. The timing, continuity, and the scope of reforms is commonly considered as the best explanation of more successful economic transition. The World Bank analysis supports the view that countries that liberalized rapidly and

extensively recover faster and experienced decline in inflation rates.[15] Finally, more successful countries in the region introduced more comprehensive macro-economic stabilization reforms, liberalized the economy, and privatized a large part of state assets.

The most important thing to understand about the privatization process in Eastern Europe is that, in contrast to other countries, privatization, in the environment of the transitional economies, is not a simple transfer of ownership from the state to private individuals, it is rather a process by which the very institution of property, in the sense in which lawyers and economists employ the term, is reintroduced into East European societies.

Parallel with the breakdown of the communist political system in Eastern Europe and the USSR, the privatization of state-owned property became the focus of discussion within and outside Eastern Europe. Because, this was the best way to replace their broken-down economies. That is why, the building of economic and legal mechanisms to put in place of the fallen communist system in Eastern Europe is one of the great dramas of the century.

This was an obvious development since state-owned property accounted for 85-90 percent of national assets of the command economies. Private ownership and privatization, which had been a taboo for Eastern European economists during the communist era, surfaced as an immediate

[15] The World Bank, World Development Report, p.83

necessity in countries that aimed for an economic and political integration in to the West. But the task of turning state-owned assets into privately owned properties turned out to be overwhelming. It is perhaps one of the most challenging tasks of our time, both intellectually and in practical terms.[16]

In 1989, successive political revolutions affected Europe. The communist systems collapsed one after the other and by 1991, all the East European countries (from Albania to the USSR and its member republics) launched a process for creating a market economy with dominant private ownership to replace their broken-down dictate economies.

The problem of privatization in Eastern Europe showed that the situation in the region was entirely different from that in the West and that the solutions adopted there could not be transplanted to Eastern Europe.[17]

The transition to capitalism requires the replacement of state management with private owners operating under effective corporate governance, the clarification of property rights, and the development of financial markets.

The most important context in which the emerging order in Eastern Europe is shaped is the moral dimension of social activity. Shifting political and moral responsibility to the individual has been an important topic of reform movements in Eastern Europe. The antidogmatic morality of human

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[16] Ivan Major, Privatization in Eastern Europe, p.1
[17] Roman Frydman, Andrzej Rapaczynski, op.cit, p.13

actions governed by individual rights and dignity informed the slogans of the Citizens Forum, Solidarnosc, and the Civic Rights movements. For Vaclac Havel, such a morality stands in opposition to the self-momentum of the system, "the blind, unconscious, irresponsible, uncontrollable, and unchecked momentum that is no longer the work of the people, but which drags people along with it and therefore manipulates them."[18]

So if the moral dimension is the first important component, the second one is privatization which is a systemic dimension. The most important task faced by the post communist countries is the development of institutional structures that connect the moral dimension with the systemic one. Here, also we see the important role of privatization because privatization is the most important connection between the two dimensions.[19]

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[18] Gregory S.Alexander, Grazyna Skapska, A Fourth Way?, p.XII
[19] Roman Frydman, Andrzej Rapaczynski, op.cit. p.141

2. Privatization in Eastern Europe

Since the term "privatization" was given wide currency by the sale of British Telecom in 1984, many developing countries have launched privatization programs and many more are in process of joining the club.[20] During the 1980s, the main proponents of privatization were nations of the developed world together with a number of Latin American nations. However, in the 1990s, the popularity of privatization widened considerably, spurred by the transition from communism in Eastern Europe and the former Soviet Union.

Privatization is now mainstream. The dimensions of the privatization revolution have been huge. The most profound change of all has been experienced in Eastern Europe and the countries of the former Soviet Union after the fall of communism, which have adopted a variety of techniques to transfer ownership rapidly to private hands. A very interesting example for Eastern European countries is that the average share of national GDP attributable to the private sector increased from 20% to more than 50% over the three year period from 1990 – 1993.

The economic benefits of privatization are now widely accepted, and may include: improving enterprise efficiency and performance; developing competitive industry which serves consumers well; accessing the capital, know-how and markets which permit growth; achieving effective corporate governance; broadening and deepening capital markets; and of course, securing the best price possible for the sale.

Privatization is always political in the sense that governments have aims that are non-economic. These can involve, as in the former Soviet Union and Eastern Europe, the swift transfer of assets to private hands, in the full knowledge that the needs of the new owners for assistance in turning the enterprises around could be dealt with later on. Other political objectives include achieving a wide shareholder distribution, targeting certain classes of buyers (and excluding others, particularly foreigners), ensuring that enterprises do not close, reducing budget deficits/raising money, and maintaining employment and social obligations. There are also political impediments to overcome primarily the conservative or sometimes obstructive attitudes of existing managers and employees of state-owned businesses, who may be afraid of the challenges of the market place.

In Eastern Europe and the former Soviet Union, the rapidly deteriorating economic conditions translated into a need for speed; the size of the economies and the transparent magnitude of the task of transformation required a need for replicability. The privatization results in Russia since 1992

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[20] International Finance Corporation, Privatization "Principles & Practice", p.2

are an illustration of this: 75,000 small-scale businesses have been auctioned; 14,000 medium and large scale firms were sold; and 30-40 million new shareholders were created. A transformation so fast, and so profound is unparalleled in recent times. The speed meant, however, that individual appraisal of each transaction was not possible.

In the former socialist economies, enterprise numbers are larger and the economic and the social importance of State Economic Enterprises (SOE) sectors are far greater than in the rest of the world. Whereas in mixed economies privatization is a tool for increasing efficiency, in the former socialist economies many view divestiture as an end itself, essential to the transformation from a command to a market system.[21] Even at their peak, the largest SOE sectors in industrial and mixed economies were small in comparison with those in socialist Eastern Europe. At the beginning of the 1990s enterprise numbers in this region were much larger than anywhere else, and SOEs accounted for between two-thirds and nine-tenths of all productive economic activity. Indeed, SOEs were not and are not a sector; they constitute, in effect, the bulk of the nonagricultural economy.

In the past, impressive production figures were reported for SOEs in most command economies. Methods of production, however, were inefficient, and the goods produced were generally poor in quality and incapable of competing in export markets. Despite persistent partial reform efforts from the 1960s onward, the SOE's never achieved the efficiency and productivity level

[21] Sunita Kikeri, Privatization The Lessons of Experience, p.73

expected of them, and their performance deteriorated sharply in the period 1970 –89. Dissatisfaction with the insufficient results of past partial reforms and the contribution of inefficient SOEs to stagnating or even declining standards of living contributed to the political economic upheaval of the past several years and to a widespread enthusiasm for privatization. All the successor governments in the region have already launched or are planning privatizations.

Privatization in the former socialist countries differs greatly from that elsewhere. First, it is a more massive and thus a more complex undertaking. For example, the governments of Czechoslovakia, Hungary, Hungary, Poland, and Romania have announced intentions to privatize between third and a half of their SOEs within a three-year period. At a conservative estimate, this amounts to more than 8,000 firms. In the 1990s the former German Democratic Republic has privàtized more enterprises than the rest of the world in the past fifteen years.

Second, the context is very different. In even the poorest or least market-oriented developing country there is always a private sector. This has not been the case in the former socialist countries.

Third, In mixed economies privatization is seen primarily as a tool for enhancing efficiency and reducing budgetary burdens. In contrast, in the former socialist economies there is a strong argument that privatization is an end in itself because it is the principal mechanism for moving the society from

communism to capitalism. Its overriding purpose is to transfer property rights to owners who have incentives for defending the interests of the capital they own. Private owners are expected to support with their votes and their actions the painful steps necessary for transformorming to a market economy. For the transition to succeed, privatization must be massive.

There is near-universal agreement in these countries on the goal of creating a large and influential group of property owners. Some go further and insist that the property transfer must be accomplished immediately, since many key decisions that will determine the nature of the postcommunist system are being made now.[22] The fear is that if privatization does not come quickly, it will take years for any substantial portion of assets to pass into private hands. And in the interim, a base could be constituted for those who see interventionist populism as the less-painful alternative to free market economics.

Other respected reformers argue that since "the principal purpose of privatization is to nurture the incentive force private ownership provides," each transaction should be structured to yield the maximum possible amount of macroeconomic and microeconomic gain and " the sale of state property should not be governed by the guiding principle of speed"[23] I believe, this view is more common in countries that had a more evolutionary than revolutionary break with communism; in these circumstances leaders are less likely to regard massive and rapid privatization as essential. For example, in Hungary,

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[22] Ibid.,p.74
[23] Janos Kornai, The Road to a Free Economy, p.175

management buyouts are the main privatization method. In contrast, in the Czech Republic the great majority of firms are to be privatized by a "voucher" method that emphasizes speed and aims at the rapid elimination of government involvement in the enterprise sector.

A very important thing to understand about the privatization process in Eastern Europe is that, in contrast to other countries, privatization, in the environment of the transitional economies, is not a simple transfer of ownership from the state to private individuals. It is rather a process by which the very institution of property, in the sense in which lawyers and economists employ the term, is reintroduced into East European societies.[24]

The socialist economies of Eastern Europe did not have any property system governing their productive activities[25] That is why, in all East European countries, it is nearly impossible to answer the simple question of who owns what in the state enterprises: the legal determination of ownership was simply irrelevant under the old system, which relied instead on directly prescribing the conduct of factor officials. The need to reintroduce the very institution of property in the productive resources of East European societies means that structural reform of the economies of these countries cannot proceed primarily on a macroeconomic level. This realization, given the recent reform efforts in a number of East European countries, is of great importance.[26]

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[24] Roman Frydman, Privatization in Eastern Europe: Is the State Withering away? P.10
[25] Ibid.,p.11

For example, the case of Poland is quite instructive. The first stage of the economic reform there, known as the "Balcorewicz Plan", consisted of a series of macroeconomic measures – such as credit restrictions, wage restraints, and reduction of subsidies – designed to arrest inflationary pressures in the economy. The effects of this series of moves were in part quite predictable: prices at first shot upwards, then inflation slowed down quite dramatically and prices remained relatively stable. Among other expected effects was a fall in production and rise in unemployment. Both of these did indeed happen, though to an extent differently from what had been expected and perhaps for reasons that had not been foreseen.

The authors of the Balcerowics Plan also expected, however, that the macroeconomic measures undertaken would result not only in the elimination of the inflationary pressures but also the creation of the basic conditions of a market economy. It was expected that the lifting of subsidies, together with other monetary measures, would result in a readjustment of prices. By bringing out a more realistic assessment of costs and revenues of each particular enterprise, this in turn was supposed to provide proper incentives for the management and put state enterprises on a sound footing. Privatization would merely complete the process begun by the macro economic reform. When the real viability of individual enterprises was going to be determined by the market, the enterprises could then be valued and gradually sold off through a variety of well known techniques.

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[26] Gregory S.Alexander, A Fourth Way, p. 129

The only way of correcting the inefficiency of post socialist state enterprises is to move as fast as possible toward a real property regime. An immediate move, of a limited scope but considerable practical importance, is to introduce a new legal system of state property. This process of corporazation would consist of an immediate transformation of state enterprises into joint-stock companies. But nothing will remove the need for speedy privatization. Privatization should not be seen as just the last stage in the process of transition from a centrally planned economy to capitalism. At the same time, it is an indispensable condition of an efficient control of management performance

There are four main premises that helped the success of East European privatization.

(i) Privatization must be accomplished quickly. If privatization is the core of the process in which the state enterprises become restructured, the economic reform in Eastern Europe cannot proceed without a radical ownership transformation.

(ii) Privatization must be socially acceptable. The East European industry, antiquated and inefficient as it is, has been built at the price of enormous sacrifices by the general population over the last fifty years. The rise in standards of living was constantly retarded by the policy of investment in heavy industrial infrastructure. Because of the sale of this industry at very low

prices, the public opinion could turn against the privatization program.

(iii) The people of Eastern Europe also have a somewhat ambivalent attitude toward privatization and market economy as a whole. On the one hand, nearly everyone understands that the move in the direction of capitalism is necessary and can be expected to yield, in the long run, significant improvements in standards of living.[27] But on the other hand, the move toward a market economy means further sacrifices, involving potentially high rates of unemployment with which the people of Eastern Europe are not familiar.

(iv) Privatization must assure effective control over the management of privatized enterprises. The move away from bureaucratic control over the economy cannot mean a simple removal of all control mechanisms with respect to the functioning of the enterprises. In other words, when the control mechanisms of the command economy are eliminated, something else must be put in their place that will play the same role, like the institutions of a Western market economy. Prime among these institutions is a system that provides incentives for managers of enterprises to maximize the interests of the shareholders which correspond to the interests of the consumers. In the capitalist societies, this task is accomplished, through a variety of institutions, such as takeover mechanisms, markets for managerial ability or an

[27] Roman Frydman, op.cit.,p. 14

elaborate banking system that supervises company management. Without these institutions, this would undermine the whole meaning of privatization, which I believe is "not a simple change of ownership, but also a radical restructuring that transforms the incentive system of the economic agents at the enterprise level.

Privatization assures access to foreign capital and expertise. Eastern European countries need Western funds, know-how and management expertise. In order to be effective, the entry of foreign capital and expertise cannot take place through a provision of advisory and consulting services. The only way, in which financial institutions can play a creative role in the region, is to have their entry based on sound business principles, so they stand to gain or lose by their activities. This means that privatization policies create conditions that make entry attractive from a business point of view.

In general, there are three methods of privatization which have been applied to Eastern Europe. First, I will try to analyze these methods and than I'll give some examples about cases from some different countries. The first type modeled after the United Kingdom, aims at the creation of viable stock markets and a system of external financing of corporate investment; it is believed that the resulting market for corporate control would have the desired disciplinary effect on the behavior of company managers. The second type, inspired by the German system, advocates a so-called internal market, that is a system in which banks and other financial institutions play a crucial role in

supervising corporate management and the financing of corporate investment. Finally, the third type is spontaneous privatization, to be initiated by the present management with the support of the workers. This type of proposal favors the preservation, indeed strengthening, of the present control structure.[28]

The East Europeans often view the stock markets as the ultimate symbol of capitalist maturity. For this reason, as well as because of the inherently non-bureaucratic modus operandi of the market, many East Europeans see stock markets as attractive devices for exercising a measure of external control over corporate management. Creation of a measure of external control over corporate management can be attempted in a number of ways. One can try to sell state enterprises to foreign and domestic investors, hoping that each firm will end up with at least one significant large owner who will take an active interest in the way it is run. Another extreme is a naked giveaway plan:[29] The population at large might receive special vouchers that each holder can exchange for the shares of a corporation of his or her choice. Through later trades, a market for the shares of the privatized companies is expected to develop and, because of the possibility of takeovers create some pressures on company management to improve performance

In brief, the sales model of privatization appears both economically and politically unfeasible. If the prospective buyers are to be domestic, there is enough capital available internally in Eastern Europe to make the sale of most

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[28] Ibid., p. 59

[29], Bruno Dallago, .Privatization and Entrepreneurship in Post-Socialist Countries, p.77

state enterprises a realistic possibility. If foreign investors are to be relied upon, because of the uncertainty concerning the stability of the region and the high cost of monitoring foreign investments, it is likely to induce the prospective buyers to impose politically unacceptable high discount on the price of East European corporations[30] Insofar as the giveaway plans are concerned, they would lead, at least initially to an extreme fragmentation of ownership, with the concomitant inability of the investors to exercise any meaningful control over management.

To explain the privatization programs about the control of management by financial institutions more easily, we have to analyze one special version of this type, which was adopted by the Polish Government for its so-called mass privatization program involving the largest 500 state enterprises in Poland.

The 500 largest enterprises were first converted into a joint-stock company. Then the 500 enterprises were disposed of in several phases, with 150-200 privatized in the first phase. An appropriate number of vouchers were issued for each phase, with two-thirds most likely going to the public at large (each citizen receiving one voucher) and one-third to the social security office (to capitalize the state pension fund) Thus the citizens received vouchers equivalent to 40% of the value of the privatized enterprises, and the state pension fund 20%.[31]

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[30] J.Franks, Capital Markets and Corporate Control: A Study of France, Germany and the UK" Economic Policy, vol.5, 1990, p.191

[31] Roman Frydman, op.cit. p.63

The State then invited the creation of a number of intermediary institutions (investment and restructuring funds), which offered their shares in exchange for vouchers. (The entry was to be free, so that any person or institution, foreign, domestic, or mixed, would be able to create an intermediary, as long as the minimum conditions specified in a special law were satisfied) The vouchers received by the citizens were to be used to purchase the shares of the intermediaries, with each person having a choice among the intermediary institutions in which they wanted to invest. The social security system had a choice of depositing all or some of its vouchers with intermediaries or of creating one or more special pension funds of its own.

Once the vouchers were transferred to the intermediaries, the 150-200 companies privatized in the first phase were to be sold at a specially designed auction. The state also deposited 30% of the shares it owned in the intermediaries according to some predetermined formula. However, the state was not to become an ordinary shareholder of the intermediary institutions; its shares were to be apportioned to the intermediaries, and the state's role in them was to be limited to appointing of one director on the board of each intermediary. The intermediaries were to be charged with selling the state's shares in each privatized company to other investors, either on private placement or in the open market.

When the transfer of ownership and control was to be completed, new directors were to be appointed by the intermediaries and other shareholders for each company, and the business of restructuring would thus begin. The

new owners would be free to change the management of the privatized companies, to split them up, to sell a part of their holdings, to approve various joint-venture arrangements between the privatized companies and other entities. The sale by the intermediaries of the 30% of the shares held by them on behalf of the state would allow for an introduction of core investors into a number of the privatized companies, as well as to create a market for a sizeable proportion of the shares of the privatized companies. This experience constitutes the method of privatization to realize corporate control through financial institutions.

The third method is spontaneous privatization. The idea of spontaneous privatization looks like an East European equivalent of a management buy-out. The pressure for this type of ownership change comes instead from an alliance between the workers and the management who are intent on resisting significant departures from the status quo: it is precisely the opposition to a restructuring that is likely to result from genuine privatization that motivates the alliance. In addition, in the Polish context at least, the change is unlikely to lead to increased efficiency; quite the contrary, one of the primary incentives towards spontaneous privatization is an attempt by the workers to get around the stiff tax on wage increases that applies to the employees of state enterprises, but which maybe relaxed for companies that privatize. So, the pressure for spontaneous privatization is primarily political, and as such it may turn out to be a threat to genuine restructuring.

Privatization refers to the process of transferring ownership rights of productive assets held by the state. Although in the contemporary East European context such a transfer is usually seen as the principal means of creating a private sector in an economy dominated by the public sector, the two processes (privatization and the creation of private sector) should not be confused. First, transferring ownership from state to private hands is unlikely to be sufficient to create a dynamic private market economy. Second, a private sector might be produced more effectively by measures to stimulate the start-up of new ventures and expansion of existing units in the nascent private sector than by transforming state assets into private assets.[32] Anyway, each government in the region looks to privatization, that is, ownership transfer, as the fundamental step toward the creation of a market economy. Now I will try to focus on the variation in privatization strategies across the three cases. How do East European governments differ in their policies for transferring ownership of the assets of state enterprises? For a typology to portray these differences, three central questions to define three dimensions must be addressed by any program of privatization.

1. How are the state's assets evaluated?
2. Who can acquire these assets?
3. With what resources are ownership rights acquired?

The Czech strategy evaluates assets directly by the market, involves participation on the basis of citizenship, and uses monetary resources. The

[32] Leo Hurwicz, "The Mechanisms of Resource Allocations", Journal of Asian Economics 14:(1991), p.55

program that the Czech economic authorities are launching involves the distribution of over 50 percent of the equity in more than 1,500 large public enterprises through a citizenship voucher scheme. Each Czech citizen over 18 years of age receives vouchers equal to 1,000 investment points. These investment points can be exchanged for shares in the enterprises designated for privatization through the voucher program. But although every citizen receives these vouchers as a matter of right, only those who pay a registration fee of 1,000 Korunas will be able to use the vouchers in the public auctions. To indicate that the equity shares obtained through the voucher program are not a free gift from the state, to signal that there will be risk involved, and to filter out citizens with no serious interest in ownership, Czech officials have designed a voucher scheme that combines citizenship participation and monetary resources.[33]

The first stage of the voucher-auction program began in 1992. Because of the complexity of the actual process of exchanging vouchers for shares Czech authorities undertook a major program to educate the public about its principles.

It is possible to summarize the major principles of the Czech strategy of privatization in three categories. First and most importantly, the Czech leadership appears committed to using a stimulated market to rapidly achieve a functioning equity market in the shares of a significant proportion of former state enterprises.

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[33] Vedat Milor, Changing political Economies Privatization in Post-Communist and Reforming Communist States, p. 125

Second, with a capital market organized around the stock exchange stimulated by the voucher-action program, the Czechoslovak economy appears to be heading in the direction of raising investments funds through markets typical of the Anglo-American system rather than through the Japanese-German system. The banks play a more central role in monitoring and directing the performance of their creditor firms in that. Third, the Czechoslovak leadership appears to be prepared to accept relatively dispersed ownership in the initial stage of its privatization program in the hope that later transactions in the actual capital market will yield relatively rapid concentration of ownership in the midlevel enterprises.

The story of Poland's privatization strategy begins in Gdansk, the birthplace of the largest independent trade union in Eastern Europe. Gdansk was also the birthplace of Polish neoliberalism. After the liberalism, property reform was on the agenda. The Mazowiecki government announced a program of clean privatization, using the British models as its centerpiece with the promise of foreign investors and large public offerings.[34] But foreign investors were slow and few. They were looking more to Hungary and former East Germany. And also, the public offerings made little dent in the state-owned assets of the large socialist enterprises.

After the election campaign in which first name was Walesa promised an increase of in the speed of privatization, he asked to elaborate and specify

[34]Andreja Böhm, Privatization in Central and Eastern Europe, p. 378

the sweeping program for mass privatization. They faced the enormous problem of the fact that domestic savings could cover only a fraction of the assets of the large state enterprises. On this subject Lewadonski the new minister of property transformation had said that "privatization is when someone who does not know who the real owner is and does not know what it is really worth sells something to someone who does not have any money"[35]

The program of mass privatization was formally announced in 1991. Calls for the property transformation of some 400 Polish enterprises occurred in the first stage of its operation. Employees in the privatized firms received a free 10 percent of the shares of their companies.

At the center of the mass privatization program, however, stands a universal citizens grant in the form of share vouchers issued to every Polish citizen. In marked contrast to the Czechoslovak program, no registration fee is required to participate. A problem lies in the dissolution of Czechoslovakia into two independent countries. The significant cross-border investment activity in the first wave, especially Slovak investments into Czech companies, suggests that the two countries will continue to maintain close economic relations.

In another variation from the Czechoslovak schemes, Polish citizens do not have to exchange their vouchers directly for shares in a privatized enterprise. Thus, in contrast of the Czechoslovak imitation of Anglo-American practices, the Poles looked to the models in Germany and Japan. But in

[35] Vedat Milor, op.cit, p. 43

general, with its unrestricted access to shares, the Polish voucher program is more inclusive than the Czechoslovak project.

Our third example of Hungary was characterized by the combination of bargained evaluation of assets, corporate owners, and positional resources.[36] Although Hungary's centralized State Property Agency (SPA) has a strong legislative mandate to supervise and control all aspects of the privatization process; asset evaluation in Hungary is not conducted through administrative means, as in Germany.

When the SPA nominated a list of 20 enterprises to be sold in the first round of privatization, the agency also announced an open invitation to investment banks and consulting firms to place proposals with the agency indicating, in general terms, how they would evaluate assets, arrange credit, and find a buyer for a given enterprise. That is, the agency put up for tender the rights to manage the restructuring of a particular company. Actually, the SPA was not directly selling enterprises but instead was selling the rights to lead and manage their privatization.

Basically, Hungarian privatization was a spontaneous process in which the managers actually gained control. In Hungary when the government sold SOEs, people accused government officials of selling them too cheaply. Then, when they raised prices, no buyers appeared with the result that privatization

[36] Andreja Böhm, op.cit. p.180

has taken much longer. But it must be indicated that, this country in the region has had the greatest performance of foreign investment. Also, Hungary is a very good example because, the early and successful privatizations of crown jewels such as telecom company MATAV, oil and gas company MOL, pharmaceutical producer Gedeon Richter and bank OTP are seen as benchmark transactions for the region. Openness to outside investment has brought a virtuous circle to the market leaders: further inflows of direct and portfolio investment and improvements in corporate governance and competitiveness.

Although there were many problems, the most ambitious privatization programs, however, have been the ones undertaken in the transition economies of Central and Eastern Europe. In these economies, all enterprises were state-owned in 1990, but by the mid 1990's several transition economies had privatized majority of them. For example, 90% of Czech enterprises passed to private hands in the period 1990-96.

As we see in East European Countries, selling state enterprises is to improve company efficiency and performance. Nevertheless, those managing the process have additional political goals and sensitivities that can complicate the decision to sell. In this sense, we see again that privatization is always political. That is why the most important lesson is that for privatization to succeed politically, it must re-enfranchise a great many people as owners. This involves more than just giving away assets. After privatization, corporate governance institutions must be established that are perceived to protect

minority interests, protect individual investors and furnish needed information. Thus the privatization process and post-privatization environment would be accepted as transparent and fair. Such acceptance is the only hope for generating large-scale political support for privatization. According to that, in countries where there was no mass privatization, the sale of state assets could not generate political support because few people benefited from it. On that point, the Eastern European countries succeeded politically and became a successful case for other developing countries.

In respect to the transitional economies, privatization needs to be understood in even broader terms than just turning the state owned enterprises over to the private sector. It must mean privatizing the economy, by which the role of the economy is reduced from that of owner to that of a regulator for its guidance and assistance role.

3.Privatization in the Czech Republic

The Czech Republic is widely considered as the star of the transition countries in Central and Eastern Europe. Its economic reforms are well advanced and its market economy is flourishing. The citizens of the Czech Republic are more strongly in favour of liberal market reforms and privatization off state owned enterprises than in any country in the region.

When analyzing the overall Czech reform package of 1991, one is struck by the pivotal importance attached to privatization, and to the originality of the voucher privatization programme. To understand the weight placed on privatization, it is important to bear in mind the initial economic and political setting. Czechoslovakia was a country that had suffered the overpowering influence of party bureaucracy and was deficient in individuals with experience in entrepreneurial activities.[37] Fast privatization was advocated for political and economic reasons. It stemmed both from the failed experience of attempted mild reforms within the old system and from the desire to remove all traces of socialism, such as state ownership.

The Czech Government believed that the absence of effective ownership rights was at the heart of the old system's inefficiencies. From the beginning, the consensus in the country was that privatization was necessary. The initial problem was formulating objectives and deciding how to proceed. Early theoretical discussion in the West tended to stress provision of incentives for better resource allocation, the fiscal benefits from revenues of sales, and monetary considerations about the absorption of the monetary projection. Lessons from privatization in Western Europe appeared limited. Privatization there was on a smaller scale and primarily involved the utilities. It usually took the form of block sale or public offering by capital markets. Such methods were not the obvious way to proceed in the Czech case.

Another important obstacle was, valuation of enterprises, which depends on judgements about the future profitability. The enterprises to be privatized did not have a market track record on which to base valuation and there were no expert financial institutions to underwrite the process. Imperfect information about policy regarding prices, taxation, credit and the treatment of outstanding debts aggravated the difficulty in formulating predictions of future profitability.

The Czech Government decided that the state must primarily distribute its holdings in the enterprise sector to the population at large for free. Beside that, the Czech Government wanted to ensure that privatization would improve management, the pricing mechanism, the structure of industry and

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[37] Saul Estrin, Privatization In Central & Eastern Europe, p.155

the allocation of capital. Liquidation of companies and questions of long-term viability were therefore intervened with changes in ownership and the clarification of ownership rights.

First, corporate governance had to be created to ensure that managers adjust their behaviour from reliance on orders from planners to those from shareholders. Principal-agent theory suggests that in the private sector contractual discipline is enforced by potential bidders and by the bankruptcy discipline enforced by creditors. Second, pressures on management were to be made effective by enterprise restructuring and the introduction of market competition through free trade and anti-monopoly legislation. Ownership reform was not intended to deal with the adjustment process by itself. It was to do so hand in hand with new bankruptcy and competition laws and within the restructuring of the banking and foreign trade systems.[38]

A series of reforms was introduced in the Czech Republic from the beginning of 1991. Measures directed at the enterprise sector have included price liberalization, the drafting of bankruptcy legislation, and the start of small scale privatization and large scale privatization. The programme also stressed a comprehensive liberalisation of foreign trade and convertibility of the currency.

The weakness of State Owned Enterprises adjustment rapidly manifested itself in the wake of transition. The drop of output was greater than

[38] Saul Estrin, op.cit., p.158

expected; GDP declined by 16 per cent in 1991 as opposed to the 5 per cent forecast. Industrial output fell even further but employment rather less. This drop in output has been mainly attributed to a fall in demand (domestic and foreign), with the inflexible response of the state-owned sector to changing demand conditions as a contributory factor.

The Czech Republic implemented a two track policy, comprising both "small-scale" privatization and "large scale" privatization. Small-scale privatization consists of the auction of shops and service establishments to individuals, mainly implemented at a local level. It envisages transfer to Czech citizens in the first instance and, only failing that, acquisition by foreigners. It is aimed at manufacturing, banking, and insurance organizations which often have a domestic monopolistic character and invariably operate on a large scale. It involves a voucher scheme to put large state enterprises into the hands of private owners. Former Czechoslovakia is thus moving towards allowing individual share ownership in most large medium-size firms both directly and through mutual funds. Privatization has also been the main way to ensure enterprise restructuring. The voucher scheme is intended to ensure the rapid transfer of state-owned property to the private sector and to offer Czech citizens a stake in the reforms.

As a result of the reform program, about 80 percent of the Czech industry, which account for about 70 percent of economic output, are regarded as privatized at the moment. In other sectors this share is even higher: in the construction sector about 90 percent, in the service sector

almost 100 percent. In view of the fact that a huge number of these companies are controlled by investments funds and these, in turn, are controlled by the big banks the majority of which are still state-owned.

Prior to 1989, there were few private enterprises in Czechoslovakia. State and cooperative property were the only ownership forms recognized by the constitution. Nationalization in the late 1940s and early 1950s had left less room for private enterprise than in Hungry, Poland or the former German Democratic Republic. The "Velvet Revolution" of November 1989 brought a democratic government to power and President "Havel to the Castle", chanted the millions of demonstrators filling the streets of Prague. The Velvet Revolution gave the signal for far-reaching changes, both political and economic.

The separation of Czechoslovakia into two independent states, the Czech Republic and Slovakia, on 1 January 1993, had a traumatic effect on a large sections of the population in both parts of the country, as well as a negative impact on economic growth. At the time it occurred, however, the separation could no longer hold back the sweeping wave of economic reform, particularly on the Czech side of the new border.

A very important approach to speeding privatization is simultaneous transfer to private owners of a large number of state-owned enterprises. Because most of the local population does not have the financial resources to buy shares on their own, the concept – for which the term "mass privatization"

has been coined – normally also embraces free distribution of ownership rights to citizens in the form of vouchers that are used to "purchase" shares in the enterprises. In addition to speed, this process has a political dimension, for it creates widespread private ownership at little or no cost to the voucher holders. It is also controversial.

On the plus side, the vouchers provide an otherwise nonliquid population to the liquidity to purchase property. Mass privatization has been touted as being one of the most equitable routes to privatization, because citizens receive equal ownership stakes. It also avoids the problem of trying to establish a share price for hundreds of individual enterprises during the early stages of economic transition-ownership rights are transferred before serious appraisal or valuation. Finally, the speed of the process limits the possibilities for unregulated spontaneous privatizations and prevents the possible deterioration of assets when the privatization program drags on over a long period of time.[39]

Also, they avoid problems of absorptive capacity and purchasing power by rapidly giving at least some ownership in a firm or firms to a population that can not-or would not- purchase it. They are equitable, since under the proposed schemes all or most of the population receives shares at no cost or is given the chance to obtain shares at low cost.[40]

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[39] "Accelerating Privatization in Ex-Socialist Economies", Global Issues In Transition, March 1994, p.47

[40] Sunita Kikeri, The Lessons of Experience, p.78

The self employment rate -measured against the number of companies in relation to the working population- has in the meantime not only reached the average EU value of 12 percent but has even slightly surpassed it. In 1997, the Czech Statistical Office listed about 1,400,000 entrepreneurs. The great majority of economic entities falls into the category of small and ultra small business.

The Czech privatization Ministry was disbanded as of 1996. In the six years of its existence the ministry had, within the overall framework of the "small privatization", auctioned off 22,000 companies, liquidated 2,000 state-owned companies, transferred ownership of 800 properties to municipalities, processed 70,000 applications for restitution and paid compensations to 2,500 co-operatives. During the "large privatizations" assets to the value of one billion Czech crowns were de-nationalised and 304 billion distributed among the population by means of vouchers. The assets still owned by the state mainly consist of 52 so-called strategic companies and stakes in about 1,400 companies which are managed by the National Property Fund. The latter is to be sold off by means direct sales within the coming years.

While privatization in the small and medium sized business is almost complete according to government statistics, with approximately 80% of all companies privatized, the more difficult large industrial privatization has yet to be implemented on the same scale.

Privatization could not solve the basic problems of the companies. The target to restructure companies and to fortify them with market economic structures for competition in a free market has largely been missed. Exceptions occurred when a (in most cases foreign) investor bought a stake in a company or took over the whole company or holds a majority of its shares, like for instance VW at Skoda, and made new investments. One reason among others the restructuring process is proceeding at such a sluggish speed is the newly created ownership structure. The companies have basically received three groups of new owners. The first group consists of about 2 million shareholders who have bought only few shares. The dominating role is played by the investment funds. According to estimates, the ten biggest investment funds manage two thirds of the fund business. The field between the small shareholders and the big funds occupied by 300 medium-sized and small investment funds which mainly concentrate their activities on the trading of shares. The small shareholders as owners are too weak and often not qualified enough to push restructuring programmes through. In addition they also lack capital. The big investment funds shun restructuring measures because of their conflicting interests. For the same big banks which are wholly or partly owned by the state and dominate lending business are, via subsidiaries, some of the most important operators in the investment funds. They can hardly be interested in a wave of restructuring which would tidy up the situation for the companies, but would on the other hand create considerable losses for creditors. The government also has to take part of the blame for the sluggish speed of the restructuring process, as a

big part of the shares in many companies are still, via the National Property Fund, held by the state.

The restructuring that never took place is now to be achieved in the "third privatization" hoped for the sale of the companies by their current owners to new investors. First steps in this direction seem to emerge presently. By the end of 1995, two-thirds of the shareholders had sold their shares, mostly to investment funds. The investment fund are not allowed to hold more than 20 percent of the shares in any single company, a fact which is not really conductive to facilitating decisions on the supervisory boards. As a consequence, some funds have started to turn themselves into shareholding companies. The investment made by shareholding companies are not restricted by the 20 percent rule, in return, however, they are subject to stricter legal regulations. The role of the new "holding companies" as active investors becomes particularly obvious by the fact that they try to fill the key position in the management of the companies in order to be able to influence the important decisions of company policy. The consequences is redistribution of ownership

Mass privatization in the former socialist countries could take several forms: simply turning ownership to the current managers and workers; making all or some enterprises into joint stock companies and distributing a percentage of shares to the current managers and workers; creating mutual funds, distributing shares to the public; distributing to the public vouchers or

coupons that entitle them to bid directly on shares in individual firms; and several variations in between.

Mass privatization is a process in which a substantial part of the economy's public assets is quickly transferred to a large, diverse group of private buyers. It involves bundling or grouping firms to be privatized, as opposed to the "classical" or case-by-case approach taken in the OECD countries and widely emulated in many developing countries in Latin America, Asia and in Hungary.

Mass privatization usually involves the distribution of shares of state enterprises to the public, either for free or for a minimal charge, generally through a voucher allocation scheme. Vouchers normally take the form of certificates or scripts distributed to the population and are convertible into shares in State enterprises through an auction process. Although mass privatization schemes and vouchers are not inevitably linked, they are generally associated with each other. In at least ten Eastern European countries and the Commonwealth of Independent States, vouchers are being used to speed the privatization process and to ensure a more equitable distribution of the wealth previously held by the state.

Allocating vouchers is just one of a number of measures used to privatize firms quickly. Other measures, such as deep discounts (including low floor prices for auctions), liberal arrangements for management and employee buyouts, transfers to entrepreneurs at book value, management contracts,

leases, and contracting out, are also used. Nevertheless, vouchers play an integral role in the mass privatization programs.[41]

The basic principle of the voucher method is as follows: state enterprises are transferred into the ownership of private citizens not for money but in exchange for investment vouchers. Every citizen over the age of 18 can buy investment vouchers, in the form of a voucher booklet, containing 1,000 investment points, a form of "investment money", for a registration fee of Kc.1,000 (US$35-originally one quarter of the average monthly wage). These vouchers entitle all citizens to bid for ownership of shares in any company included in the voucher privatization scheme, or to entrust their investment points to an investment fund, making investment decisions centrally and holding a diversified portfolio.[42]

The primary objective of mass privatization programs is to create the base for a market economy by privatizing state enterprises as quickly as possible. Given the initial conditions in most formerly socialist countries, such as limited private capital formation, a lack of interest or confidence from foreign investors, political limits on the sale of state enterprises to foreigners, and the need to involve citizens in the economic transformation process through widely distributed ownership, policymakers in many of these countries have decided to initiate mass privatization programs. The overall objectives of such programs are:[43]

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[41] Robert Andersen, Privatization and restructuring in Central and eastern Europe, p.3
[42] Rolph Van der Hoeven, Lessons From Privatization, p.15

- Political: attempting to involve and commit the population at large to the economic transformation process.
- Social: seeking some form of distributive equity through the distribution of shares to the general public.
- Economic: quickly privatizing a large number of firms to deepen market forces and competition within the economy.

Some former Soviet Bloc countries have moved slowly toward democracy and capitalism – while others abandoned reform parties for resurgent neo-communist ones. However, for a number of reasons the Czech Republic has made a swift transition to a free market economy with a minimum of trauma and has the most stable government in the region.

The result of market reforms is evident in the Czech Republic:

✓ Gross domestic product grew by 4.5 percent in 1995 and is currently growing at 6 percent a year.

✓ Industrial production has been rising at a rate of more than 9 percent for two years in a row.

✓ Per capita income already equals that of Portugal, a member of the European Community, and inflation is less than 10 percent a year.

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[43] Andreja Böhm, Privatization in Central and Eastern Europe, p.152

- ✓ Unemployment is the lowest of all European countries at 3.5 percent.

- ✓ The government budget is running a surplus and foreign capital is flowing into the country.

Among the factors that account for Czechs successful reforms since its first non-communist government came to power in November 1989 are:

- ✓ The region was heavily industrialised for generations before the post-war Communist take-over.

- ✓ It is a Western European country in every sense political, economic and cultural.

- ✓ Reformers, led by the non-Marxist economist Vaclav Klaus, planned carefully for a year and acted decisively beginning in January 1991, including decontrolling prices and making the currency convertible

- ✓ Mass privatization of 2,500 state enterprises through vouchers has moved the economy from 2 percent private ownership in 1990 to 80 percent today.

Industrial production fell by 35 percent during the privatization process, as inefficient state enterprises were liquidated. However, Klaus prepared the

public in advance by repeatedly explaining the necessity and benefits of reform.[44]

All fundamental structural changes forming part of economic transformation in the Czech Republic were completed in 1995. Whereas in 1989, when 98% of all property was owned or directly controlled by the state, the major part of all economic activity occurred in the private sector in 1995, when about 70% of gross domestic product was created by the non-state sector. Whereas in 1989, approximately 90% of all prices were regulated by the state authorities, in 1995 the state only regulated rental payments for apartments and most energy prices (electricity, gas, coal, etc.). Whereas in 1989, all wages were under direct state control, in 1995 the government abolished all regulatory measures in this field. Before 1995, a certain amount of wage control still existed in order to prevent inflationary pressure.

Privatization by the voucher method has allowed millions of Czech citizens to become small shareholders, and also gave rise to several investment privatization funds. This laid the foundations for very fast development of the domestic capital market. In turn, the existence of the capital market was the necessary prerequisite for the process of concentrating capital in the hands of strong, active investors. Such a process must take place in the Czech Republic because it is the only way of creating an ownership structure similar to those found in all advanced countries. The introduction of free convertibility of the Czech crown in 1995, by the passage

[44] Roger W.Fontaine, Red Phoenix Rising? Dealing With the Communist Resurgence in Eastern Europe, p.2

of an amended Foreign Exchange Act, can be regarded as the culmination of the transformation process.

The economic results of 1995 also confirm that progress is being made in economic reform. In the first years of the transformation process, a major decline in production took place, manifesting itself in falling gross domestic product and national income. However, an upturn in the main indicators of economic growth was observed in 1995. The national income rose by 4.1% in 1995.

Other indicators also signify macroeconomic stability. Overall inflation was around 9,5% in the mid 1990's, unemployment did not exceed 3.1%. Also the state budget showed a moderate surplus and the size of the state's internal and foreign debt declined. Foreign-exchange reserves increased to such a level that it became possible to declare the national currency freely convertible. So far, this step has had no effect on the long-term stability of the exchange rates of the Czech crown. However, the non-production sphere still mainly accounted for the creation of reserves because the balance of trade remained in deficit.

The second and probably the last wave of voucher privatization was completed in 1994. Using this form of privatization, about 60% of all property and shares earmarked for privatization as part of large scale-scale project privatization were realized.

On the one hand, it is possible to say that the mass privatization process was concluded, but on the other hand, a large volume of shares and property remain to be privatized. There are several reasons why the remaining property cannot be privatized by the voucher method. The most important is the need to obtain, through the privatization of the residual state property and shares, the necessary funds for dealing with the most pressing problems inherited from the communist period (financial compensation under restitution laws, support of institutions set up for resolving the problem of doubtful receivables, expenses for redressing old environmental damage, funds for the construction of the Ingolstadt oil pipeline, etc.)

In contrast to the preceding years, when the main privatization strategy was to make the privatization process as speedy as possible, much greater attention was given in 1995 to the amount of funds obtained through privatization. Thus the basic strategy has become not only to privatize at a fast rate-the new requirement is to privatize not only speedily but also in the most effective way.

The methods employed today are keeping with this strategy. Privatization in the Czech Republic can be described as mass utilization of standard privatization methods. For example public auctions, tenders, direct sales and sales of shares through the capital market.

The Czech Republic's leaders recognized the need for speed and impracticality of privatizing thousands of enterprises by traditional methods

within a short time. Their solution was voucher privatization, with restructuring to follow post-privatization. To accommodate differing views of how privatization should proceed, however, their decision was modified to allow firm managements – or anybody else- to propose their own plans for privatization. The ensuing deluge of proposals, many of poor quality, swamped the Ministry of Privatization, and the result was that the first round of voucher privatization was delayed by almost two years. Vitally-needed restructuring of firms in crisis could not wait that long.[45]

As stated above, mass privatization involves giving away ownership of state-owned firms to all citizens. The Czech republic pioneered this method in 1991 and privatized more than 1500 firms by 1994. In some cases, a portion of a firm's shares were reserved for sale using conventional methods. A citizen was given (for a nominal charge) a coupon which could be used to buy shares in a national auction in any firm included in the program.

Citizens could bid in any of the firms included in the program. Alternatively, they could decide to turn over their coupons to an investment fund and thus become part owner of a much larger and diversified portfolio. Almost anyone could establish a fund with minimal regulation. About 70% of the coupons were turned over to 550 funds that became the dominant owners of Czech firms.[46]

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[45] Andreja Böhm, op.cit.p.148
[46] Robert E.Anderson, op.cit.p.13

Mass privatization has brought into existence 1,680 joint-stock companies which replaced the original state enterprises and the transfer of shares with a total nominal value of 363.000 million crowns from the hands of the state into the hand of small shareholders, individual citizens and several investments privatization funds.

The Czech program is top-down and a bottom-up approach. It is top-down, because the privatization law requires that all large firms be privatized. It is bottom-up, because state enterprises or bidders prepare their own privatization plans, which are reviewed by the relevant ministry and by the ministries of privatization

After 1995, the results of mass privatization began to appear in day-to-day life. New shareholders appeared on boards of directors and the supervisory boards of privatized companies-representatives of privatization investment privatization who have now begun to exert pressure on the management of companies. The other shareholders, such as individual participants in voucher privatization who invested directly in privatized companies are beginning to realize that they have practically no chance of influencing company affairs.

It is possible to regard the most important result of mass privatization as the coming into existence of a large number of new economic entities, independent of the state, and of an enormous number of shareholders, and the related development of the capital market. The voucher privatization

process also had a not insubstantial educational effect, because it showed millions of people what it means to be a shareholder, what transactions can be carried out with shares, when dividends can be paid out and acquainted them with a number of useful facts necessary for correct orientation in the market economy.

Those who expected that the new shareholders would immediately begin to perform their functions as owners were probably disappointed. Investment privatization funds and all the other shareholders whose existence originated in the voucher privatization understandably behaved, in most cases, as passive investors. As a rule, they were mainly interested in selling their shares as profitably as possible, and in obtaining money by transactions on the capital market. Such shareholders participated to a relatively small extent in the creation of active business concepts of companies.

After the end of voucher privatization, the national Property Fund owned financial interests of varying sizes in more than 1200 joint-stock companies (besides strategic interests companies). Mostly, they were the shares that remained unsold after voucher privatization (the voucher privatization technology used in the Czech Republic did not make it possible in practice to sell all the shares that were offered). However, the National Property Fund was also left holding some shares for other reasons (e.g. prospective purchasers approved by the government lost interest in acquiring shares, negotiations with potential foreign investors were not concluded, joint stock companies did not purchase all the staff shares which they had

originally requested, etc.) In this connection, it is necessary to point out that the National Property Fund's interests in the various companies differs greatly, and ranges from fractions of one per cent to majority interests.

In this category the main privatization strategy is to privatize at a fast rate and to maximize yields. An overwhelming majority of these shares is therefore being sold through the capital market or by tender. Priority is being given to the privatization of majority and large interests because the National Property Fund is determined to quickly divest itself of responsibility for important business decisions which must be taken by the actual long-term owner or controlling shareholder.

In selling shares on the capital market (in particular on the Prague Stock Exchange), the National Property Fund is using the method of "block sales", which means that it offers for sale blocks of shares, usually representing a certain percentage of shares in specific companies. This sales technique is based on the Dutch auction principle, whereby a seller gradually reduces the original absurdly high asking price of the block of shares offered. The deal is made when, on the demand side, three is a party ready to accept the price at which the whole block of shares is offered. By means of this technique, the National Property Fund has been obtaining prices which are twice as high, on average, than the official stock exchange prices.

Public tenders are mostly used when significant interests are being privatized in companies whose shares are not traded on the capital market, or

when it can be expected that in such a public competition, it will be possible to increase the number of potential buyers, and thus also to increase the selling price of the shares offered. The main difference between public tenders and "block sales" on the capital market is the extent of information provided by the National Property Fund as seller. Whereas in public tender, the company whose shares are being sold prepares extensive information for distribution, but in block sales, all information must be obtained by the investors themselves.

This concerns property which, in contrast to the above group, is not owned by the National Property Fund but is still owned by the state some property is still managed by state enterprises or other state organizations. In a number of cases, the National Property Fund has difficulties in privatizing such property. For example, a buyer approved by the government maybe unable to present proof of its ability to pay the purchase price. The basic strategy of the National Property Fund in such cases is either to complete privatization under the terms specified in relevant decision or, when an approved decision cannot be implemented for objective reasons, The National Property Fund proposes that the decision be amended. Such a change, however, must be approved by the authority that had issued the original decision (the government, or the Ministry for Management of National Property and its Privatizaion)[47]

[47] Andreja Böhm.op.cit.p.141

The privatization methods in use in the Czech Republic do not make it possible to combine on a mass scale the process of privatization with centrally controlled restructuring processes. It is generally expected that structural changes in individual enterprises will be carried out by the new owners.

Within the privatization process, only those enterprises created by administrative decisions of communist institutions and whose operations could not be economically justified were broken up. Active restructuring controlled by the state is only being carried out in several of the most important companies included in the category of strategic interest companies included in the category of strategic interest companies. An example is the restructuring of the petrochemical and refining sector. After a government decision, Unipetrol is being built up as a strong holding company which will comprise all major enterprises operating in oil transport, processing and distribution of oil products. With government approval, a consortium of foreign oil companies is involved in the refining subsidiary. Such examples of centrally-controlled restructuring being connected with privatization are rather exceptional but also exist in the mining and metallurgical sectors.

Among enterprises in the private and social services sectors which were included in the privatization process have, in particular, been enterprises providing communal services (refuse collection, cleaning and maintenance in towns, etc.) companies distributing water, electricity and gas, housing enterprises and a certain proportion of health service institutions. In contrast, not included were schools (elementary, secondary and institutions of higher

learning), social institutions (institutions providing care to mentally and physically handicapped persons and children), and several other institutions of national status (The National Theatre, the National Museum, the Academy of Sciences and similar institutions).

No special methods were devised for privatization of the above enterprises. In addition, they were privatized by either transformation into joint-stock companies and subsequent privatization of their shares, or by direct privatization-sale of property or its assignment to the community without cost. To by far the biggest extent, communities took part in the privatization of the public sector; for the most part they acquired property for free, especially property which by its character is associated with community requirements rather than business purposes, for example, water distribution, sewerage and other systems, property facilitating communal cleaning and maintenance of parks, etc.

Some property area of concern is privatization of the health service. Included in the privatization process was a majority of outpatient health facilities, and a portion of small and medium-sized hospitals. Prior to privatization, health facilities were divided into two categories. Category A included health facilities which were freely privatizable and category B facility, the Ministry of Health set minimum requirements regarding the extent of health services which the new owners must provide for a period of at least ten years after privatization. In the event that new owners fail to fulfil such an obligation, the National Property Fund can impose high financial penalties,

and when even this is not sufficient to ensure redress, the National property Fund can repossess the property concerned by exercising its retained pre-emption right, and repeat the privatization process.

Most health establishments were privatized by direct sale on the basis of submitted privatization projects. Usually, prices were set at the level of the book value of the privatized property, just as in the case of privatization of property in other sectors. Where there were several potential buyers of one health facility, usually the tenderer was chosen who, according to their professional qualifications or business project, best met the requirement of health services that are to be provided within the appropriate category of health service institutions. Only in the case of most attractive health service institutions, for which there were several applicants with comparable qualifications or similar business projects, were tenders invited and property sold to the tenderer offering the highest price.

In contrast to the other sectors, privatization in the health service was supported by the state by means of preferential credit arrangements. Thus when a buyer obtained credit from a bank for payment of the purchase price, part of the interest payments were defrayed by the State. When a bank, for example, granted credit at 15% interest, the buyer paid only 9% and the state remaining 6% of the interest. Only in the cases when there was no potential buyer, were transfers of health facilities to communities without payment approved. In a majority of cases, communities leased such facilities to doctors.

This chapter has attempted to illustrate the scope and depth of structural change achieved in the Czech Republic during the ten years since the 1989 Velvet Revolution. After this transitional period, the share of private sector employment increased from 1 percent in 1989 to 60 per cent at the end of 1993 and over 80 per cent by the end of 1995. More than 1 million jobs have been created in the small private enterprise/business sector, which was almost non-existent five years ago. In the period of 1990-94, many small and medium-sized private enterprises were successfully developed. The number of private entrepreneurs and small business owners increased from an estimated 70.000 in mid-1989 to about 600,000 in mid-1994 in the Czech Republic alone.[48] The number of companies (limited liability, joint stock and public limited companies) in Czechoslovakia went up rapidly during 1991 and 1992. In the Czech Republic the number is estimated to have doubled between January 1993 and July 1994. At the same time, the number of state enterprises declined. The pace of decline was relatively moderate at the beginning of the reform process, but it took momentum as the so-called large scale privatization started. By now, most assets are in private hands.

Privatization in the Czech Republic has correctly been treated as a part of a broader process of structural change.[49] The success of privatization in the Czech Republic lies in its flexibility. Privatization in this country has mostly been distinguished by its comprehensive variety of methods and its speed. The Czech Government succeeded very well on their principle of privatizing

[48] Rolph Van der Hoeven, op cit.p.155
[49] Saul Estrin, op cit.p.157

as quickly as possible and leave to the owners the restructuring. Mass privatization in the Czech Republic resulted in a much more concentrated ownership structure than was originally predicted. Control of these firms also encouraged restructuring and speeded up the transition to a market economy.

4. Lessons, Overall Evaluation, Conclusion

The collapse of communism in Eastern Europe demonstrated the failure of a command economy. The subsequent crash in output and employment induced by "shock therapy" has suggested the limits of a laissez faire economy. Rather than replace the excesses of communism with excesses of capitalism, it was time to lay extreme ideology aside and begin the practical work of economic reconstruction.[50] Beginning in the late 1989, economic reformers in Eastern Europe began lifting controls on prices, foreign exchange restrictions, subsidies to business and barriers to trade. The shock treatment did have some beneficial effects. Manufactured exports to the West have risen. Small private enterprises have succeeded, and unemployment in Warsaw, Budapest and Prague has been practically nil.

That was the good news. The bad news was that in the rest of Poland, Hungary, Slovakia, the Czech Republic and the less developed nations of the former East bloc, ten millions of people remain dependent on state-owned enterprises that are not competitive under free-market conditions. It was not economically feasible simply to shut these enterprises down. In these

[50] Alice H.Amsden, Beyond Shock Therapy: The Path To East European Recovery, p18

circumstances, East European intellectuals, even most social democrats, have tended to embrace privatization as part of a radical free-market model.

No nation has ever built a modern industry under the conditions imposed on Eastern Europe. The world's fastest growing economies like Japan, South Korea and Taiwan have tended to follow ways almost opposite to those commanded to postsocialist Europe. The practical question was how to restructure this old economy. The answer was privatization. Privatization was a necessary condition for the market mechanism to work, because it holds promise to governments of generating revenues through sales of public property. And, privatization helped create a new entrepreneurial middle class that values hard work and liberal political democracy.

As was implied in the previous chapters, one of the main purposes of privatization in Eastern Europe is to contribute towards the creation of a well functioning market economy. It is hard to imagine such an economy without a large private sector. A second, not unrelated objective of privatization, is to create conditions conductive to raising productive efficiency in all its dimensions; such as lowering costs of production, improving product quality and variety, improving innovative behaviour. Third, for governments facing difficulties in raising revenue and balancing the state budget, privatization can provide a means of raising some revenue. Fourth, if revenue considerations are not so central, then equity arguments may dictate that privatization should

be conducted in such a way that the ownership of former state-owned assets should be relatively distributed across the population.[51]

Privatization is considered a cornerstone of the transition process for all of Eastern Europe. While some countries, such as Bulgaria and Romania are still in the process of setting up a fully defined privatization scheme, other countries, notably the Czech and Slovak Republics, Hungary and Poland, already have their basic systems in place. The discussion on the role of privatization in the process of transition focused on the speed of privatization, and it was far from clear whether privatization should lead or follow the process of transition.[52] Proponents of slow privatization put forward three basic arguments.

- macroeconomic stabilization, domestic price liberalization and account convertibility have to precede privatization because efficient decisions can only be made on the basis of correct relative prices.

- Introduction of competition policies and account convertibility has to precede privatization to prevent monopoly profits.

- Introduction of modern tax systems and accounting procedures, and financial and capital market reforms, have to precede

[51] Saul Estrin, op.cit.p.33

[52] Paul Cook, Colin Kirkpatrick, Privatisation Policy and Performance, International Perspectives, p.36

privatization to allow for proper enterprise valuation. Proponents of fast privatization basically pointed toward the broader macroeconomic consequences of continuing to burden the economy with a large and inefficient state enterprise sector for decades to come.[53]

By now it has become widely accepted that the transition from planned to market economy, and urgently needed improvements in enterprise efficiency are impossible to occur without extensive and rapid privatization. This view is reflected in the mass privatization programs that are discussed and set up in countries like Czechoslovakia, Romania and Poland. Poland for example, after initially experimenting for about nine moths with UK style one-by-one privatizations, that involve valuations, prospectuses, subscriptions, underwriting etc. found it necessary to broaden its approach in the Summer of 1990 after experiencing very slow progress with its original approach.[54] With all Eastern European countries swiftly implementing macroeconomic stabilization policies, domestic price liberalization and current account liberalization, arguments for delaying privatization were significantly weakened. The rapid progress that was achieved on devising mass privatization schemes that would allow for fast nominal divesting of state assets while delaying the question of asset valuation, further strengthened arguments in favour of a fast and comprehensive privatization.

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[53] Hemming, Privatization, p.80
[54] Paul Cook, op.cit.p.37

There are elements that are common to east European privatization programs, such as the largely demand-determined early privatizations of companies in good financial condition. However, only Romania has an explicit program for enterprises in good financial health. There are also marked differences among East European countries, particularly with respect to the acceptance of mass privatization and the acceptance of foreign investment. In general, domestic credit in Eastern Europe is severely constrained, particularly in relation to that available to potential western buyers. Therefore, in the absence of mass privatization schemes, domestic credit constraints would make sales to foreign investors almost inevitable. In Hungary, for example, the rejection of mass privatization has necessarily meant a strong openness to foreign investment. Other countries, particularly those in which mass privatization is expected to play an important role, have sometimes placed more restrictions on foreign investment. Rigid controls on foreign investments have usually been reasoned out by the need to ensure harmony of interest between enterprises and nations regarding long-term corporate strategies. In Poland, for example, foreign investments require special approval by the Agency of Foreign Investment if the par value of the shares bought by a foreign investor exceeds 10 per cent of the share capital of the enterprise.[55]

The privatization of small enterprises, mostly retail stores and enterprises in trade and services, has proceeded with rapid pace across Eastern Europe, while privatization of large enterprises, such as mines, still,

[55] Ministry of Privatization, Privatization Transactions, Poland, 1991

shipyards, petrochemical complexes, oil refineries and textile factories, has been proceeding with much slower speed. This has been due to two main reasons.

- Large enterprises usually have an old obsolete capital stock and employ old production technologies, and may therefore be unlikely to attract buyers at positive prices.

- Large enterprises account for a big share of employment and production in the economy, and privatization or shut-down may be politically difficult.

Still, it is clear that ultimately there may only be two solutions for these enterprises: (i) shut-down and liquidation in parts; or (ii) massive investments to modernise the capital stock. Given that few local individuals have the financial resources to carry out the necessary investment, governments have three basic choices:

- Find ways to attract foreigners on a large scale,
- Establish diluted share ownership by local individuals via mass privatization,
- Break up the existing large-scale enterprises into smaller units that are privatized separately.

The Eastern European privatization experience, as discussed above, would seem to lead to a number of preliminary policy lessons for other governments wishing to reduce an overextended public sector.

Those who take part in the debates on privatization are frequently asked whether they recommend fast or slow privatization. The question is constructed in the wrong way. No one would call oneself an advocate of slowness. The debate should not be about the speed, but about the decision of values, the role assigned to the state, and the assessment of the importance of the various forms of ownership and types of owner. Once anyone takes a position on these points at issue, the speed to be expected arises as a result of that decision. The procedure of privatization should be as fast as possible. But it can not be accelerated by some artful trick. Finding some intelligent organizational form plus bureaucratic aggressiveness in enforcement are not sufficient conditions for fast privatization.

Privatization is a cornerstone of the transition from planned to market economy. Therefore, it must be accomplished in a speedy and comprehensive fashion. The rapid creation of a legal framework that defines ownership rights is clear. Given a variety of policy objectives and a highly differentiated demand for the existing portfolio of state assets, the use of a broad set of privatization tools helps speed up the process. For example, separate privatization programs for small commercial units targeted at domestic buyers. Reliance on UK style one-by-one privatization is time

consuming and slows down the process of transition. Foreign investment should generally be welcome.

People are more willing to bear an inevitable burden if they can expect tangible benefits. To be socially more acceptable, any privatization scheme should have a distributive component. Creating broad-based ownership rights, as envisaged under the various mass privatization programs, facilitates income policy reform and supports efforts to reform social policy. For the same reason, management and employee buy-outs and employee ownership programs should be encouraged.

Some local and national government ownership is compatible with the establishment of a market economy. Given the enormous size of the public sector, the provision of public goods and services as well as selected activities in various sectors is likely to continue to be in public hands over the medium term.[56] Still, given the extent of investments that Eastern European economies require to bring their domestic energy, telecommunications, and transport sectors up to modern standards which private sector already has. In other word, private sector solutions should be encouraged.

It is important to realize that privatization is not an end goal but rather a means of accomplishing a larger goal of economic development and stability.[57] Privatization is therefore an essential, but insufficient element of structural reform. Even where mass privatization occurs, and the sell-off

[56] Robert Andersen, Privatization and Restructuring in Central and Eastern Europe, p.45

process is accelerated, as in the Czech and Slovak Republics, there is clear recognition that this is only the first phase of structural reform.

Structural change and adjustment in the transition countries will be a long, drawn out process and both political and public support are limited in terms of time. Unlike mass privatization, which capitalized on political capital and momentum with striking speed, post privatization structural change and adjustment issues will require careful thought and planning.. Comparative analysis of the Czech and Slovak, Polish, Russian, and Lithuanian mass privatization models indicate that during the initial steps of privatization it is better to run the risks of imperfect competition and markets, and to accelerate the process, than it is to delay privatization. As we witnessed in the third chapter, the mass privatization program in the Czech Republic is complete. However, the complexities of enterprise restructuring, corporate governance, capital market development and competition policy must be addressed if the fruits of the privatization are to be enjoyed.

The Eastern European experience indicated that privatization needs to be viewed as a very important part of a more comprehensive reform program. This lesson is maybe the most important lesson to draw from experiences to date. While privatization has created the underlying base for the development of a properly functioning market economy, that base cannot be built upon if the appropriate support system is not installed. Therefore, the East European

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[57] Ira W.Lieberman, Mass Privatization in Central and Eastern Europe and the Former Soviet Union, p.47

experiences offer important lessons and serve as valuable guidelines for countries about to start on the long path towards free markets.

The importance of privatization in Eastern Europe is measured in both quantitative terms (extent in proportion to the initial public sector) and qualitative terms(its political acceptance)[58], This can be explained by the determinants identified in the following analysis. Privatization is a function of;

1) The degree of democracy (assuming more democracy reduces the role of pressure groups and allows tighter control of elites and managers), and international intellectual openness, or international control of the national economy (IMF, World Bank), possibly due to public finance difficulties and international borrowing.

2) Political equilibrium (the level of redistribution demand, the extent of satisfaction of this demand through public sectors firm)

3) Public Finance factors, or the instrumental theory of redistribution supply

- Taxes, interest rates, efficiency, openness of financial markets
- Greater elasticity of supply and demand following openness to international trade.

[58] Herbert Giersch, Privatization at the End of the Century, .p3

4) Economic structures and institutions (development of financial markets, economic markets, property rights and legal systems, etc.) that affect the potential benefits from privatization.

It is apparent from this analysis that a broad political and economic equilibrium specifying the determining factors of privatization policy highlights the role of genuinely political factors in public choices. Upstream from these political factors, however, lie economic factors, either structural or liable to change in the shorter term, which, through the optimization pursued by political agents, help to explain the unequal success of privatization policies in different East European countries.

That is why, it is my view that there is no single best transformation strategy for all transforming economies. The best strategy will depend on each country's legacies, initial conditions, and current circumstances. And no country can be expected to follow any of the pure models. The actual strategy of transformation is likely to combine elements from each, although circumstances in a given country may make it more receptive to one of the approaches than to another.

In brief, privatization has reached a critical juncture in the former Communist bloc. While large swaths of industry have been transferred to the private sector in countries like the Czech Republic, private ownership is just beginning to have an impact on how firms are managed and also how economies perform. In this perspective, there are two important issues in

assessing the impact of privatization on the transitional economies of Eastern Europe.. The first is depoliticization of economic decisions. Politicization was widespread in the region, ranging from direct sale oversight of resource allocation to outright state intervention. The second important issue is the enterprise reform, in the sense that the enterprises should be working better. In terms of de-politicization, the picture is a little mixed. In countries that have carried out large scale privatization programs the state is undoubtedly not as dominant. But even in countries like the Czech Republic, where privatization has been pushed very far. The state is still present. Therefore, the de-politicization goal has only been partially achieved in most countries in the region. On the other hand, I believe it is early to assess what the real impact of enterprise reform. It is in the long term that one can see the effect of privatization.

The most important lesson here, is that privatization has to succeed politically. This involves more than giving away assets. After privatization, corporate governance institutions have been established for the protection of minority interests. Thus as the privatization process, the post privatization process must be transparent and fair. Such acceptance is the only hope for generating large scale political support for privatization.

During the reform programs in Eastern European countries, privatization is always in part a political process, so democratic institutions affect privatization. For example, as stated in chapter three, the Czech Republic had the largest mass privatization program in the region,

enfranchising many of its citizens and thus generating a tremendous momentum in favour of reform.

In countries where there was no mass privatization, the sale of state assets could not generate political support because few people benefited from it. For example in Russia, the perception has been that certain groups, rather than the population as a whole, have benefited from privatization. Therefore, the process has contributed to a split in the society. In Slovakia, privatization also benefited specific groups

Technically, an important lesson from the experience in Eastern Europe is that, the voucher system privatization works better than outright sales of state owned companies. Voucher privatization is the only way to do large-scale privatization in the region. The local population has too little money and foreign demand is insufficient. The only foreign investors that enter these countries are corporations which bring their own management. The portfolio money through financial markets is very limited due to the countries inadequate financial infrastructure and poor information on corporate performance. The only way to privatize large holdings is to start by giving shares away. The government is unable to sell these enterprises via bloc sale because it does not have enough contacts or expertise, with the result that the process is too centralized. They may claim the price is too low or too high, the assets is a national treasure.

On the other hand, when assets are distributed as in the Czech Republic, the intermediaries sell on behalf of the beneficiaries of the funds. Therefore, many Czech citizens benefit from those sales. Contrast this with the situation in Hungary, when the government sold State Owned Enterprises, people accused government officials of selling them too cheaply. Then, when they raised prices, no buyers appeared with the result that privatization has taken much longer. It has to be emphasised that this is the country in the region which has had the greatest influx of foreign investment.

At least voucher privatization provides a chance to foster the emergence of market institutions. That is much more important from the point of view of investment and growth than restructuring a particular enterprise.

A tremendous amount of effort has been spent in Central and Eastern Europe to privatize state-owned economies almost completely. Once the state has an economic role on a scale such as that it had in Communist Eastern Europe, the political interests that develop are so strong that it is truly difficult to get the state out of the economy. Therefore, should try as much as possible to ensure that the state does not become too involved in their economies. It is very difficult to de-politicize these economies. It might even be possible to privatize them, but that does not necessarily depoliticize them. Many Latin American economies have been mostly privately owned, but the private sector had been so intervened with state that the relationship probably affected half of those economies until liberalization and other free-market reforms were implemented. For example, Brazil once had tremendous import quotas to

benefit private the industry. That was not good for the Brazilian economy. This is a lesson for which one did not have to go to Eastern Europe. Of course the Eastern European communist governments that brought about the present economic disaster did not worry about this. In fact, their express goal was to make their economies as centralized as possible

In tracing the evolution of privatization and examining the approaches and results of some privatization programs, it is essential to keep in mind that privatization is fundamentally a political transformation, that is, a change in the government's role in the economy and in society as a whole. Because of the magnitude of this transformation, it can be accomplished only with great difficulty, something that is characteristic of any fundamental change.

This is not to say that privatization is an answer to all economic problems or even that it will remedy the problems that it is intended to remedy. This is also not to say that a government should not own any enterprises. It is important to note that almost all countries have at least some SOEs, which are necessary in sectors that do not lend themselves to private competition. Basic services, such as energy, water, waste treatment, and the like are good examples.

The problems with SOEs develop when they assume too large a role in the economy, operating in domains that would be more efficient if left in the hands of the private sector. Privatization confronts this problem by removing encumbrances that accumulate after years of state ownership, thereby letting

the private sector unleash its energies and resume its rightful role as the engine of economic growth.

For this strategy to be effective, the conditions necessary to support a thriving private sector must be in place. This is why privatization will not succeed unless it is carried out in conjunction with reforms designed to create or strengthen market-based economies. This is also why it is harder to privatize in the ex-socialist countries, because they must literally create a private sector at the same time that they privatize—truly a formidable journey through uncharted waters.

The debate over privatization is fundamentally a political debate. After all, in democracies old and new, it is the citizens who must decide what functions they want government to perform. When government cuts back, individuals and groups who used connections to obtain government support in one form or another will use those same connections to impede changes perceived as injurious to their interests.

For this reason, privatization requires a great deal of political courage. Especially in new and fragile democracies, such courage is hard to come by. This suggests that privatization techniques that cultivate and maximize political support for the process will have the best chance for success. Even

with such techniques, however, success will come slowly, with economic hardship often the most immediate and noticeable result.

In the end, governments face a difficult balancing act, having to impose short-term pain as the price of long-term gain. For citizens looking for a better future, particularly in the developing and ex-socialist worlds, the promise of long-term gain is a rich one indeed. Privatization offers such promise, along with the chance for citizens to become owners and investors in former state enterprises and thereby assume greater control over their economic destinies. Like their political leaders, they must also exhibit great courage as they meet the challenges posed by privatization.

There are grounds for optimism. The course of privatization is not ultimately set by the wisdom or stupidity or the strength or weakness of East European governments, opposition forces, foreign governments, international organizations, or consultants. At most, these groups may slow down or speed the events. The process is directed by an irresistible inner force: the inherent motivation of the present and future private owners.[59]

Most of the privatization programs implemented thus far have proven to be economically successful, but this does not mean that the process of privatization has become foolproof.

[59] Kazimierz Z.Poznanski, The Evolutionary Transition To Capitalism, p.53

There are important reasons to conclude that the most challenging privatizations have not yet been attempted. For one thing, most governments have wisely chosen to privatize the "easy" companies (the healthiest, both economically and operationally) first, and have not yet attempted controversial privatizations of companies that are obviously over-staffed and excessively indebted. Given that these SOEs will require painful financial restructuring and massive layoffs before they can attract private buyers, it seems clear that the most politically difficult privatizations lie in the future.

In spite of these difficulties, the future of privatization is bright. In country after country these programs have yielded greater and more immediate economic payoffs, with less economic and political pain than expected: investors around the world have demonstrated there is an amazing demand for privatized equity. Furthermore, the secondary impacts of privatization—which often include greater respect for private property rights and individual entrepreneurship—have helped many nations develop the infrastructure of a dynamic market economy in a historically compressed time frame.

Perhaps the most important reason to be optimistic about privatization's future is that the three largest developing countries appear on the verge of launching large-scale divestiture programs, and are doing so from positions of considerable strength. China, India and Russia, which collectively represent over one-third of the world's population and are already the third, sixth, and ninth largest economies, respectively, on a purchasing

power basis, have all experimented with privatization, but in all three cases large sections of the economy remain state-owned. The privatization programs in these three countries will be truly revolutionary in scale and scope. If these programs are successful, they will provide a valuable example for many other countries to follow.

Many of these reforms can lead initially to unemployment or a further deterioration in the standard of living for a significant segment of the population. Although the freeing of prices resulted in stores filled with products that had been scarce or unavailable under the communist regime, it also meant high inflation and consequent reduction of wages or pensions. A popular joke of the time summed up the situation nicely: "Under communism, we had money, but there was nothing to buy. Under capitalism, everything is there to buy but we have no money."

I suppose the sentence of Winston Churchill summarises the result of transformation and privatization efforts in Eastern Europe in a perfect way; *"the inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."* [60]

There is always a danger in speaking about "East European Privatization" because, there are as many different stories as there are countries, each with a slightly different economic and political starting point,

[60] Richard Rose, William Misler & Christian Haerpfer, Democracy and Its Alternatives, p.86

culture and history. It is important to identify that across the region the majority of formerly state-owned enterprises are now in private hands. And more importantly, states that have made the greatest progress in creating market economies are also the seven countries that have made the greatest progress in consolidating their democratic transitions, in other words in becoming liberal democracies.

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