Time to Rethink Privatization in Transition Economies?

Privatization has won the day in transition countries . . . or has it? Where have privatization efforts—particularly those in Central and Eastern Europe and the former Soviet Union—succeeded, where have they failed, and how can these countries best pursue further privatization?

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PRIVATIZATION appears to have swept the field and won the day. More than a hundred countries, on every continent, have privatized an estimated 75,000 state-owned companies. Assessment after assessment has concluded that privatization leads to improved performance of divested companies and that privately owned firms outperform state-owned enterprises. This has been conclusively proved in industrial and middle-income countries, and there is increasing evidence that privatization yields positive results in lower-income and transition countries as well.

In the transition countries, the evidence of good results comes mainly from Central and Eastern Europe and the Baltic states. Evidence—early and fragmentary, but impossible to ignore—from farther east—Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Mongolia, Russia, and Ukraine—shows less promising results:

- Private ownership often does not lead to restructuring (that is, making changes to position a firm to survive and thrive in competitive markets).
- Some partially state-owned firms perform better than privatized companies.
- In some countries, there are few differences in performance between (wholly) state-owned and privately owned firms.
- In other countries, there are clear performance improvements only in those very few firms sold to foreign investors.

What is the explanation for these poorer results, and what should the affected transition governments, and those who assist them, do to improve these results?

Russia's experience

Russia's privatization experience illustrates the problems. The mass privatization program of 1992–94 transferred ownership of

more than 15,000 firms through a distribution of ownership vouchers. A worrisome result of this program was that "insiders"—managers and workers combined—gained control of an average of about two-thirds of the shares of privatized firms. Still, by the fall of 1994, hopes were modestly high that privatization would lead the way toward rapid transition to a market economy. Financial discipline would, it was anticipated, start to force secondary trading in shares of insider-dominated companies and introduce outside ownership, and transparent and sound methods would be used to privatize the half or more of industries still in state hands.

This, by and large, did not happen. First, insiders—particularly the workers in the newly privatized firms—deeply feared outside ownership and a loss of control (and jobs). Second, because the financial and physical conditions of many firms were unattractive, not many outsiders were interested in acquiring their shares. Third, there was an acute lack of defined property rights, institutional underpinnings, and safeguards for transparent secondary trading; this further discouraged outside investors. Fourth, various Russian governments failed to put in place supporting policies and institutions—such as hard budget constraints, reasonable taxes and services, and mechanisms to permit and encourage new business entrants—that might have channeled enterprise activity to productive ends.

Worse was to come: a donor-led effort to persuade the Russian government to sell at least a few large firms using transparent and credible "case-by-case" methods produced few results. Much of the second wave of privatization that did take place—in particular, the "loans-for-shares" scheme, in which major Russian banks obtained shares in firms with strong potential as collateral for loans to the state—turned into a fraudulent shambles, which drew criticism from many, including supporters of the first, mass phase of Russian privatization.

Others concluded that not just the second phase of privatization but the whole approach was wrong; that it should have been preceded (not accompanied) by institution building; and that the proper way forward would be to concentrate on strengthening the structures of the state, especially mechanisms to manage public firms.

Czech Republic's experience

By 1995, the Czech government had divested more than 1,800 firms in two waves of voucher issuance, sold a group of high-potential firms to strategic investors, and transferred a mass of other assets to previous owners or municipalities. In 1996, then prime minister Vaclav Klaus claimed that transition had been more or less completed and that henceforth the Czech Republic should be viewed as an ordinary European country undergoing ordinary economic and political problems. At the time, almost all economic indicators supported this judgment.

In 1998, however, GDP contracted by more than 2.5 percent. The Czech economy is in recession—in contrast to 4–5 percent annual expansion in neighboring countries. There are many reasons for the slide, but much of the blame is placed on the way privatization was carried out.

An Organization for Economic Cooperation and Development (1998) report states that the Czech voucher approach to privatization produced ownership structures that "impeded efficient corporate governance and restructuring." The problem was that insufficiently regulated privatization investment funds ended up owning large or controlling stakes in many firms privatized through vouchers, as citizens sought to limit their risk by transferring their vouchers into these funds in exchange for shares in the latter. But many of the largest funds were owned by the major domestic banks, in which the Czech state retained a controlling or majority stake. The results, say the critics, were predictable.

- Investment funds did not pull the plug on poorly performing firms, because that would have forced the funds' bank owners to write down the loans they had made to these firms. The state-influenced, weakly managed, and inexperienced banks tended to extend credit to high-risk, unpromising privatized firms (whether or not they were owned by subsidiary funds) and to persistently roll over credits rather than push firms into bankruptcy.
- The bankruptcy framework was weak and the process lengthy, further diminishing financial market discipline.
- The lack of prudential regulation and enforcement mechanisms in the capital markets opened the door to a variety of highly dubious and some overtly illegal actions that enriched fund managers at the expense of minority shareholders and harmed firms' financial health.

While the most visible reasons for inadequate enterprise restructuring are weaknesses in capital and financial markets, the voucher privatization method itself—with its emphasis on speed, postponement of consideration of many aspects of the legal/institutional framework, and initial atomization of ownership—is seen as the underlying cause.

Other countries' experiences

Other countries that tried mass privatization schemes—such as Albania, Kazakhstan, Moldova, and Mongolia—have not yet gained much from their efforts. Dispersing ownership among inexperienced populations seems not to have led to effective governance of firm managers, who in all too many cases have not changed, have failed to restructure, and have remained largely unaccountable for their actions. These experiences and factors are being used to justify a slower, more cautious, more evolutionary, and more government-led path to ownership transfer.

Summary of critique

In many transition countries, mass and rapid privatization turned over mediocre assets to large numbers of people who had neither the skills nor the financial resources to use them well. Most high-quality assets have gone, in one way or another (sometimes through the "spontaneous privatization"

that preceded official schemes, sometimes through manipulation of the voucher schemes, and perhaps most often and acutely in the nonvoucher second phases), to the resourceful, agile, and politically well-connected few, who have tended not to embark on the restructuring that might have justified their acquisitions of the assets. In many instances where ordinary citizens managed to obtain and hold minority blocks of shares in high-quality firms, they have been induced to turn over these shares to others at modest prices or have seen—without warning or much subsequent explanation—the value of their minority shares fall to nothing.

These outcomes have been most pronounced where the post-transition state structures have been weak and fractured, allowing parts of the government to be captured by groups whose major objective is to use the state to legitimate or mask their acquisitions of wealth. (Poor outcomes can also occur when stronger governments fail to create a modicum of prudential regulation for financial and capital markets.)

The international financial institutions must bear some of the responsibility for these poor outcomes, because they requested and required transition governments to privatize rapidly and extensively, assuming that private ownership would, by itself, provide sufficient incentives to shareholders to monitor managerial behavior and encourage firms' good performance. Although the international financial institutions recognized the importance of competitive policies and institutional safeguards, they believed these could be implemented later. The immediate need was to create a basic constituency of property owners: to build capitalism, one needed capitalists—lots of them, and fast.

But capitalism requires much more than private property; it functions because of the widespread acceptance and enforcement in an economy of fundamental rules and safeguards that make the outcomes of exchange secure, predictable, and widely beneficial. Where such rules and safeguards are absent, what suffer are not only fairness and equity but also firms' performance. In an institutional vacuum, the chances are high that no one in or around a privatized firm (workers, managers, creditors, investment fund shareholders, or civil servants managing the state's residual share) will be interested in or capable of maintaining the long-run health of its assets. In such circumstances, privatization is as likely to lead to stagnation and decapitalization as to improved financial results and enhanced efficiency.

Can the problem be corrected?

In many transition countries with weak institutions, privatization's promise has not been fulfilled. Some therefore argue that the best course of action for such countries is to postpone further privatization until competitive forces and an enabling institutional/governmental framework are in place. With regard to what has already been done, there have been calls for the renationalization of some or many divested firms, with the intention of undoing the damage inflicted and managing these assets more in the public interest, through greater state involvement—possibly with these firms being "reprivatized" at some later date.

Renationalization may not appear to be a highly likely option, but it has been proposed in and for Russia and Ukraine and even by some officials of the present government of the Czech Republic. Despite its prima facie appeal, it would be a desperate measure, with a high likelihood of failure, particularly in those countries of the former Soviet Union where its adoption is most likely to be strongly urged. Renationalization would involve selecting some or all of the most egregiously misprivatized firms; putting them back into the state's portfolio; managing them adequately while there; and then, eventually, selling them again, this time correctly.

The problems are obvious. How many transition governments outside (or even inside) Central and Eastern Europe could reasonably be expected to undertake this process and handle it well? How many can prevent asset stripping in state-owned companies or have demonstrated a capacity to divest firms in an open, transparent manner, in accord with the established standards of international practice? Regrettably, there are few. The irony is that countries with the skills and will to run state-owned firms effectively and efficiently are usually the same ones that can privatize well. Conversely, the forces and conditions that lead governments to botch privatization are the same ones that hinder decent management of state-owned enterprises. The conclusion: renationalization is not the alternative; instead, ways must be found to privatize correctly and to set and enforce performance standards for those firms that are already privatized. The crucial question, of course, is how this can be done.

One view runs as follows: in institutionally weak and politically fractured transition countries, long removed from or never fully integrated into the Western commercial tradition, privatization of the remaining portfolio (majority or minority stakes) should be halted and efforts shifted toward strengthening market-supporting institutions. The goal of such efforts would be to channel present "wild east" commercial activity into socially productive and acceptable modes, and to impose discipline on, and competition in, the remaining public enterprises. These steps should be accompanied or followed by staged, incremental shifts in ownership patterns, in a more or less evolutionary manner, as has been done in China. This proposed solution, too, has a prima facie appeal. But, again, it assumes the existence of the end at which it aims—an effective state mechanism and institutional framework.

The overall assessment thus appears bleak: privatize incorrectly and the result will not be increased production, job creation, and increased incomes but rather stagnation and decapitalization. But keeping enterprises in the hands of a weak and venal state is likely to lead to much the same thing. In both instances, the evident medium-to-long-term solution is to build up the administrative, policymaking, and enforcement capacities of the government.

Can anything be done in the shorter term? Several transition governments have tried to compensate for managerial and institutional deficiencies and a lack of political consensus by contracting out much or all of the privatization process to private agents and advisors. Armenia, Bulgaria, Estonia, Poland, and Uzbekistan are among the countries that have tried or are contemplating this approach, the Estonians with documented success. These efforts attempt to circumvent political constraints and find technical solutions to perceived political and institutional difficulties by turning over significant responsibility and decision-making power to the agents employed. This delegation or contracting out is an option well worth considering, but it is far from a general—or, indeed, a speedy—solution (as Poland can attest). And the effectiveness of the effort will, as always, depend heavily on the existence of a modicum of governmental capacity.

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Based on experience with privatization in Poland, Romania, Russia, and Uzbekistan, the World Bank's Itzhak Goldberg (1999) argues for a particular form of reprivatization. He suggests that the principal obstacle to progressive restructuring in privatized firms in Russia and elsewhere is the excessive concentration of ownership in the hands of insiders, who lack the means and incentives to lead the firms forward. Goldberg accepts the futility of renationalization and argues instead for increasing the capital in privatized firms and then immediately diluting the stakes of insiders by selling the new shares to external investors.

Once again, the political and institutional deficiencies elaborated above deeply affect both the likelihood that a government will undertake reprivatization or will succeed in implementing it, even if the government makes a sincere effort to do so. The implication is that the reforming elements in the transition governments and the international assistance community—international financial institutions, the European Union, and bilateral donors—should abandon efforts to privatize firms as rapidly as possible and instead attempt to carry out slower, case-by-case and tender forms of privatization following established international procedures.

Conclusion

It is time to rethink privatization, but only in those transition countries where history, geography, and politics have resulted in seemingly laudable economic policies producing clearly suboptimal outcomes. In Russia and elsewhere, too much was expected of privatization.

But admissions of error should not be overdone. When it can be carried out correctly, privatization is clearly the right course of action. Recall that in a number of Central and Eastern European transition countries the policy is an undoubted success, far superior to letting the firms remain in state hands. It was not clear at the outset of transition how difficult privatization would prove in institutionally weak countries (and those commentators who claim they have long perceived this did not offer a clear alternative strategy), or that a fair amount of time was available in which to carry out reform.

One must continually ask what was and is the alternative to privatization. It is not clear that Russia would be better off today had it not undertaken the mass privatization program of 1992–94. Several other institutionally weak transition economies that avoided or delayed privatization or approached it more cautiously—such as Belarus, Bulgaria, Romania, and Ukraine—have made little economic progress (though in no case, of course, is privatization or its absence the whole explanation). Armenian officials, for example, vigorously argue that despite the problems their privatized firms have experienced, the absence of domestic or foreign purchasers gave them no choice but to proceed with voucher privatization. They insist that even weak private owners are better than state ownership. Were they still in state hands, these firms would be making irresistible claims on nonexistent public resources, threatening all the hard-won progress Armenia has made in developing a market-oriented economy. The same argument could be made for other transition countries.

So, in sum, privatization is the generally preferred course of action, but its short-term economic effectiveness and social acceptability depend on the institutional underpinnings of capitalism described earlier. If these underpinnings are missing but government is effectively working toward their construction or reinforcement, then delaying privatization until the government's efforts have borne fruit might be the optimal course of action. Hungary and Poland offer cases in point.

The heart of the matter is whether and how privatization can be achieved where governments are unwilling or incapable. The necessary long-term course of action is to support measures enhancing governments' will and capacity (assuming that one knows what these are). The reasonable short-term course of action is probably to push ahead with case-by-case and tender privatization and reprivatization, along the lines espoused by Goldberg and in cooperation with the international assistance community, in hopes of producing some success stories to emulate. F&D

References:

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