Privatization Is Transition—Or Is It?

Josef C. Brada

The difference between socialism and capitalism lies in the ownership of property; the former is a system where nonhuman productive resources are primarily socially or state owned, while in the latter they are mainly owned by private individuals. Thus, only if transition economies are able to make large and lasting changes in the ownership of productive assets away from the state and toward individual owners will they make the transition from socialism to capitalism. How to bring about such a change in ownership is bound to be a difficult and contentious issue.

Proponents of creating large private sectors as quickly as possible in transition economies offer both political and economic arguments to support their view. They argue that if democracy is to become a viable political system in the countries undergoing transition, the state’s monopoly over the bases of political power must be broken so that countervailing sources of political influence may emerge (Berger, 1992). Otherwise, the *nomenklatura*, managers of state-owned firms and former bureaucrats, may sabotage or block economic reforms, as well as loot, dissipate, or transfer to their own possession the assets of the firms they manage (Blanchard et al., 1991). By creating property owners, privatization can create a nascent middle class that has a stake in the creation and maintenance of an effective system of property rights and the pursuit of economic policies that would enable the private sector to flourish (Lipton and Sachs, 1990; Comisso, 1991).

The most compelling economic reason for privatizing state-owned enterprises in the transition economies is that as units of production—as distinct from providers of secure employment—they were a failure. Private ownership is thus seen as

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the means of unlocking gains in productivity by stimulating productive efficiency, offering greater motivation for both managers and workers, and creating incentives to enter new markets and exit declining ones. Privatization, it is argued, will unleash dynamic small businesses, act as a lure for foreign direct investment and speed the painful process of restructuring industry. And it would accomplish all this while returning property to its rightful historical owners and raising funds for the government.

Despite this enticing list of promises, many countries of eastern Europe and the former Soviet Union remain reluctant to privatize. Some of the opposition is ideological. Some comes from insiders at state-owned enterprises, both workers and managers, who fear the loss of income and power. More broadly, there are fears that privatization will reduce employment as private owners dismiss redundant workers and that the new private sector will be unlikely to provide the social benefits—like housing, health and nursery care, and recreation, sports and vacation facilities—that state-owned enterprises often provided. At the extreme, there are fears that if privatization exacerbates unemployment and causes declines in production, reformist governments will be swept away.

Practical difficulties have compounded this resistance to privatization. The valuation of firms is difficult because capital markets barely exist, accounting statements can be almost meaningless, and profits and sales achieved in the communist era are a poor guide to future viability. Households in these countries do not have sufficient savings to purchase many of the largest firms, and, even if they did have the money, they view former state-owned enterprises as dubious investments. With a rudimentary banking system, loans for the purchase of state property are seen as both risky and inflationary. In this muddled situation, suspicions naturally arise that buyers are benefitting from low prices at the expense of the state.

Against this background of controversy, this paper will first describe the chief methods of privatization that have been employed across eastern Europe and the former Soviet Union in the first half of the 1990s. Then, it will try to summarize the overall impact of privatization, both in terms of what has been done and how it has affected the firms, their governance and their performance.

**Methods of Privatization**

Early debates tried to identify the single best means of creating a private sector. Given the broad range of assets to be privatized and the different ways in which social property was created—at first through nationalization or seizure but later through state investment—a variety of techniques has proven to be necessary: restitution to original owners, sale of state property, mass or voucher privatization and the growth of the private sector “from below” through the formation of new firms.

**Privatization through Restitution**

Restitution of property expropriated by the state has been used where former owners exist and can demonstrate their past ownership. Restitution has involved
buildings and real estate, and also agricultural land. How much privatization can be achieved by restitution is determined in part by history (how easily can previous owners be located) and in part by political decisions about which acts of expropriation to redress and which former owners to compensate.¹ In most eastern European countries, restitution has been the main means of privatizing agricultural land, and it has also played a significant role in privatizing housing and fostering the emergence of a small business sector. In other countries, especially in the former USSR, restitution of farmland or real estate to original owners has been unimportant.

After 1945, some eastern European countries carried out land reforms that broke up large estates and distributed land to smallholders. The latter were then forced to join collective farms (except in Poland), much as had been done in the USSR in the 1930s. Members of collective farms retained nominal ownership of their land and in some cases even received rent payments. However, collective farm members exercised no control over their land, and, if they left the collective, their property rights ceased. In the USSR, land was the property of the state (Wadekin, 1982, pp. 72–80).

In theory, returning agricultural land to former owners or their heirs gives them the right to determine how to use their land and to sell or lease it, although, in practice, restitution laws have tended to limit these rights, for example, by requiring new owners to engage actively in farming. The restitution of agricultural land is daunting because land records are incomplete and individual land parcels have long been incorporated into the large fields of the collective farms. Despite these obstacles, Bulgaria, for example, has received over 1.7 million claims for the restitution of agricultural land, and by early 1993, 23 percent of arable land had been returned.

Elsewhere, land restitution is less important. In Poland, private ownership was the predominant form of agricultural organization, and there were few collective farms to privatize. In Hungary, the Compensation Act provides that former owners receive interest-bearing vouchers that can be used to purchase land or other assets being privatized. In much of the former USSR, where collective farm members were not de jure owners of land, the privatization of farmland is proceeding much more slowly; in Ukraine, for example, only 3 percent of farmland was in the hands of individual farmers in mid-1995.

The restitution of land previously utilized by collective farms could disrupt agricultural production because new private farmers face small land holdings, lack capital and suffer from inexperience with farm management. Moreover, private plots may be in the midst of the fields of a larger operation. To deal with this

¹ In some countries, limits on the size of land holdings have been imposed to prevent restitution of very large estates; in other countries, a distinction is made between nationalizations and land reforms of pre-communist governments and those carried out by communist regimes. The return of church property, which sometimes includes large land holdings and other economic assets as well as places of worship, is also the subject of considerable controversy.
problem, most of the eastern European countries have passed legislation promoting the reconstruction of "real," as opposed to "socialist," cooperatives, or of corporations that will lease land from their members. How different these new cooperatives will be from their predecessors remains to be seen, making it difficult to judge the extent and depth of privatization brought about in agriculture.

Restitution has also been applied to apartments and houses, shops, restaurants and other small properties, where the chief difficulty often is for the new owners to dislodge current occupants. In the case of larger properties, such as factories, mines, and so on, state investment has usually become commingled with the original property, so the most common form of restitution is to provide compensation to former owners in the form of cash or vouchers. The value of capital privatized through the restitution of nonagricultural property is difficult to judge. In the Czech Republic, restitution of larger properties was expected to account for 5–10 percent of all state property; in Slovenia, which has a very ambitious restitution law, the estimate is 10 percent of social property (Gray and Associates, 1993, pp. 49, 137).

Privatization Through Sale of State Property

The bulk of industrial assets and a good part of the housing stock in transition economies were created as state property during the communist era. Since no former owners to whom this property could be returned exist, a common response was to sell these properties, often to workers or managers at favorable rates. The sale of state property was intended to meet several goals: producing revenue for the state, hastening the process of restructuring firms, and getting foreign investors involved in the economy. There was some dispute over whether the state should first rehabilitate firms and, only once they were viable, sell them to new owners at a higher price. This latter pattern had been followed in the United Kingdom and Argentina, but, given the past failures of state ownership and the large number of firms to be privatized, the usual decision was to try to sell the firms quickly, even with antiquated capital, redundant workers and poor financial prospects.

The most successful part of the programs to sell state property to new owners has been the sale of small service establishments like shops and restaurants. For example, in the Czech Republic, 26,000 such establishments (or leases for their use) were auctioned off between 1990 and 1992, raising an amount equal to 3.4 percent of GDP and 4.7 percent of government expenditures in 1991 (OECD, 1993). In Poland, from 30,000 to 80,000 units were sold in 1992 (Frydman et al., 1993), and in Hungary, where the private ownership of such establishments had been allowed previously, 8,700 had been sold by mid-1993 (Mihályi, 1994b, p. 367). Where this sort of privatization program has been pursued with vigor, it has created numerous small private businesses, albeit concentrated in retail and catering. In general, these programs have been among the most popular and least difficult aspects of privatization.

The sale of large state-owned enterprises to private investors, whether domestic or foreign, has proven much more controversial and generally less successful. In-
deed, only Germany has been able to privatize the bulk of the state-owned enterprise sector through the sale of the state-owned enterprises of the former east Germany by the Treuhandanstalt (Treuhand). The Treuhand had two objectives: to privatize the firms in its charge as quickly as possible and to ensure that the firms it privatized would be able to compete and survive after privatization. The second responsibility was often passed on to buyers by requiring them to put forward a business plan that called for keeping each state-owned enterprise in its current line of business and that established employment and investment targets for the future. Between 1990 and the end of 1994, when its privatization activities ceased, the Treuhand disposed of 13,000 state-owned enterprises.

Although the Treuhand succeeded in privatizing the industry of the former East Germany, the cost was substantial. Prices charged for firms being sold were low, and the Treuhand often paid new owners to take over state-owned enterprises and to guarantee their future. Thus, in the course of its existence, the Treuhand took in $50 billion but spent $243 billion on privatization. Moreover, the use of investment and employment guarantees by the Treuhand is a two-edged sword. It ensures that the new owners will not strip and liquidate their new holdings; however, it also assures that firms remain in the same line of activity, which slows the process of needed structural change. Compliance with buyers’ guarantees must be monitored, which requires an ongoing bureaucracy. It is claimed that 20 percent of all buyers have been unable or unwilling to meet their contractual obligations.

While the Treuhand was quite successful in privatizing industry, its success rests heavily on the fact that East Germany was absorbed into a united Germany. This provided the Treuhand with the resources to subsidize buyers of privatized firms, and it also assured a large pool of potential domestic (meaning West German) buyers with extensive assets of their own and access to the West German capital market. Such conditions do not exist in the other transition economies.

The sale of state-owned enterprises has also been the preferred path to privatization in Hungary. There, state-owned enterprises were required to convert themselves into corporations whose stock was held by the State Property Agency (SPA), which in turn selected and prepared firms for privatization through initial public offerings, auctions, direct negotiations with buyers and management buyouts. State-owned enterprises were also permitted to self-privatize by engaging consultants who would prepare the firm for privatization and seek out a buyer.

Sales of state-owned enterprises in Hungary have relied heavily on foreign investors, who accounted for about half of the SPA’s $1.6 billion in privatization revenues in 1990–93 (Mihályi, 1994b, p. 373). By the end of 1993, the SPA had privatized about 30 percent of the capital that it held, although, for some sectors of Hungary’s relatively concentrated industry, private ownership already predominated (OECD, 1995b, pp. 112–3). The flow of foreign direct investment into Hungary has been relatively large, and foreign investors have often provided new funds, technology and access to global markets.

The Hungarian experience also highlights a number of drawbacks of sales as a means of privatization. The process is slow, and it creates uncertainty for the
managers of corporatized but state-owned enterprises. The SPA was a passive owner, not only leaving managers in operating control of their firms but also allowing them to undertake "spontaneous" or "wild" privatization measures such as arranging low-price sales to foreigners. The reliance on foreign investors exacerbated the politicization of the privatization process, which is why the heads of the SPA have resigned or been replaced with considerable frequency. Because the most viable firms were selected for the early waves of privatization, several recent privatization efforts have failed to attract the requisite investor interest and privatization revenues declined in early 1995.

Many transition economies cannot replicate the experiences of Germany or Hungary. They lack a pool of domestic investors; high inflation has eroded savings; and investors do not view corporate shares as a useful investment vehicle. Foreign investors often are dissuaded by political and economic instability and unclear property rights. Often, the result is that firms can only be sold at preferential prices to insiders. For example, in Croatia, workers may purchase up to 50 percent of the shares of their enterprise at preferential prices, with payments spread over a five-year period; if no outside buyer emerges, the state remains as a passive part owner.

**Mass or Voucher Privatization**

In a program of mass privatization, eligible citizens can utilize vouchers, distributed free or at nominal cost, to bid for shares of state-owned enterprises and of other assets that are being privatized. Most of the eastern and central European countries, many of the successor states of the USSR, and Mongolia have implemented or are planning programs of mass privatization.\(^2\) Vouchers, in effect, create a stock of savings that matches the stock of state assets being privatized.

In the Czechoslovak case, state-owned enterprises were required to transform themselves into corporations, and those selected for privatization had to prepare privatization plans. Outsiders were also permitted to submit privatization plans for state-owned enterprises; on average, nearly four competing plans were proposed for each firm being privatized. On the basis of these plans, some firms were privatized by nonvoucher methods, including tenders and direct sales to new owners, including foreign investors. Ultimately, 1,491 state-owned enterprises, 988 of them from the Czech Republic, were included in the first wave of voucher privatization, which ran from October 1991 to December 1992, and a second wave, from August 1992 to November 1994, privatized a further 861 firms in the now-independent Czech Republic.

To participate in the bidding for enterprises, eligible citizens had to purchase a coupon booklet for the equivalent of $1.25 in U.S. dollars and then register it for about $35. Bidding for shares took place in rounds, five for the first wave and six for the second. Before bidding began, participants could allocate some or all of their points to Investment Privatization Funds (IPFs), who would then bid for shares

\(^2\) For descriptions of the various plans, see Mihályi (1994a), OECD (1993) and OECD (1995a).
on behalf of their investors. A computerized system matched bids and supply, adjusting prices according to certain preset rules.9

The Czech voucher privatization program succeeded in two ways. First, in combination with other privatization measures, between 65 and 90 percent of all assets in the Czech Republic are now privately owned (Coffee, 1994). This proportion is far higher than for neighboring countries who have not used voucher schemes. Second, the voucher scheme was popular. In the Czech Republic, 77 percent of eligible citizens participated in the first wave, and an even higher number in the second wave. The program clearly brought considerable political popularity to its chief proponent, then Finance and now Prime Minister Václav Klaus.

The major concern expressed about the voucher privatization is that investors gave 72 percent of their points to IPFs in the first wave and 64 percent in the second. Moreover, these holdings of points were concentrated: for example, the largest 14 investment groups controlled 55.5 percent of all vouchers available in the first round. Because most of the IPFs were founded by banks, what has emerged in the Czech Republic is an ownership structure seemingly more similar to the German and Japanese bank-centered model of ownership of firms. Those who prefer the Anglo-Saxon model of many shareholders and active capital markets find this troubling; those who prefer a bank-oriented model find it comforting.

Poland’s voucher privatization, approved in October 1994, seeks to combine broad public participation with a concentration of shares in the hands of large investors. State-owned enterprises to be privatized through the program will be transformed into corporations and their shares will be distributed to new owners. Sixty percent of each firm’s shares will be given to National Investment Funds (NIFs), organized as closed-end mutual funds. For each state-owned enterprise being privatized, a lead NIF will receive 33 percent of the enterprise’s shares and obtain four of the nine seats on the firm’s supervisory board. The block of shares held by the lead NIF can be sold or traded only in its entirety, thus ensuring the existence of a more-or-less controlling ownership interest in each firm, a measure intended to provide at least one owner with a strong interest in monitoring the firm. The other 14 or so NIFs will share equally in 27 percent of the privatized firm’s shares. The firm’s employees will receive 15 percent of the shares for free, a measure acknowledged by many observers to represent compensation for the workers’ loss of control over the firm. In the near term, the remaining 25 percent of shares will be held by the government. Polish citizens will be able to purchase shares in the NIFs for a nominal price. These shares will eventually become tradable and, in the interim, should pay dividends.

It is not clear how this balancing act between concentrated ownership and broad participation will work. The NIFs will replace the strong insider influence of workers’ councils, but the supervisory boards of the NIFs will consist of political

9 See Czechoslovak Federal Ministry of Finance (1992) for a full description of the process. Singer and Svejnar (1994) suggest that share prices reflected firm characteristics, suggesting some measure of market rationality.
appointees, and it is uncertain that they will have the skills, resources or incentives to manage firms. With the government's 25 percent shareholdings likely to be sold only in the future, and the lead fund's 33 percent holding salable only as a block, only the workers' shares and those of the other NIFs will be tradable, resulting in a thin market.

Both the Czech and Polish voucher privatizations aim to put outsiders in control of firms. In Russia, voucher privatization reduced the ownership role of the state and distributed ownership broadly, but in a way that left insiders firmly in control. Unlike the Czechoslovak vouchers, which were denominated in points, Russian vouchers had a face value of 10,000 rubles and could be used not only for bidding on shares of firms but also invested in investment funds or used to purchase housing and property in the small-scale privatization. Each citizen was eligible to purchase a voucher for 25 rubles, and 95 percent of the population did so, although because the vouchers were not registered to the buyer, many people sold their vouchers to other individuals or investment funds. Over 600 investment funds were organized, but they garnered only 30 percent of the population's vouchers.

A Russian state-owned enterprise slated for privatization was transformed into a corporation and auctioned off by a so-called Local Property Fund (LPF), because, given Russia's size, centralized sale of shares was considered too cumbersome. The workers could choose among several options for privatizing the firm. The most common one, chosen about 70 percent of the time, allowed workers to purchase 51 percent of the stock at a price 1.7 times the assessed value and at least 50 percent of the payment had to be in the form of vouchers. The remaining shares went to the LPF for disposal. Given the high rates of inflation, the fact that assessed value was not adjusted for inflation, and that payment for shares could come from enterprise funds, the cost of shares was quite low relative to the economic value of the firm. In effect, the first stage of the privatization process established insider control over the firm at prices that, given the rate of inflation, were nominal at best.4

The second phase of the voucher privatization featured auctions in which outsiders—individuals, foreigners and investment funds—could bid their vouchers for the shares made available by the LPFs. Bidders would deposit their vouchers and agree to take whatever price emerged from the bidding process, or they could set a reservation price above which they would not wish to purchase shares. Shares

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4 The second most popular choice of workers was a plan where they received 25 percent of the firm's shares for free, with an option for them to buy an additional 10 percent of the shares at a preferential rate. The remaining shares went to the LPF, which was required to auction off at least 29 percent of the firm's shares and could sell the remainder. Under a third option, which applied only to large state-owned enterprises and was used only rarely, the manager would sign a contract with the LPF to keep the firm in operation and to maintain a given level of employment for a two-year period. If the contract is fulfilled, managers may purchase 20 percent of the stock at assessed value, paying for it over a three-year period. In addition, all employees can purchase, at a 30 percent discount, 20 percent of the stock in the form of voting shares.
that remained from this process may be retained by the LPF or sold for cash. These auctions ran from December 1992 to June 1994.

In quantitative terms, the Russian mass privatization achieved impressive results: it privatized nearly 16,000 state-owned enterprises, employing about half the industrial labor force, in less than two years. While the process was sometimes chaotic, the administration of voucher privatization did not compare unfavorably with that of other government activities. However, the result is that firms are largely controlled by insiders and local government authorities, which raises questions about their future governance. For example, because the voucher privatization offered such great benefits for insiders, managers were unwilling to fire workers prior to privatization, because losing one’s job also implied the loss of rights to the firm’s shares. As a result, the official unemployment rate in Russia remained quite low, although many workers were on reduced hours or received no pay but continued to be listed as employed.

As these examples illustrate, the strengths of the voucher method are speed and relative transparency. Voucher privatization may produce less political opposition from insiders than an outright sale, because it is less likely to wipe out insider power. Some of the dangers of the voucher method raised before mass privatization programs were implemented—the inflationary consequences of issuing vouchers, the lack of interest in share ownership, massive selling by low-income holders of shares, and so on—have largely proven irrelevant. The most interesting aspect of voucher privatization is that, by expected or unexpected means, relatively concentrated share ownership has emerged, although concentration has not always been what was originally hoped for.

**Privatization from Below**

The growth of the private sector has proceeded not only through the privatization of state-owned property but also through the start-up of new businesses by indigenous and foreign entrepreneurs. The emergence of these new private firms, many of them small, is poorly documented. The statistical record does not distinguish between new start-ups and small firms that emerge from restitution, spinoffs from state-owned enterprises, or other forms of privatization. Data include many so-called “phantom” small firms and proprietorships established for tax purposes so as to allow individuals to write off ordinary expenses against nonexistent business activities, but fail to include many profitable entrepreneurs who are evading taxes.

The available data do show that the number of small business units increased quite rapidly in most transition economies. In Hungary, where the small nonfarm private sector was perhaps strongest in eastern Europe prior to 1989, the number of registered individual entrepreneurs increased from 320,000 at the end of 1989 to 766,000 in September 1994, and private economic organizations from 25,000 to 211,000 in the same period. In Russia, where private activity had been largely suppressed, there were 440,000 partnerships and 220,000 individually owned private enterprises by mid-1993, while in the Czech Republic, the number of registered entrepreneurs reached one million in 1993. Much the same patterns can be found
in many other transition economies, with Poland generally regarded as having the most dynamic small-business sector.

The growth of small-business ownership has flourished particularly in construction, domestic retailing and trade, and services. In the Czech Republic and Poland, for example, the private sector in 1994 was already providing over 75 percent of construction output and 90 percent of retail sales. Many of these private firms came into existence through restitution, small privatization and other privatization methods—not as new start-ups. Nevertheless, these figures, which reflect the situation in other transition economies as well, do show a growing entrepreneurial spirit. Activity of small firms has tended to lag in industry, either because size is a barrier to entry, or because the creation of small firms in the tertiary sector is a natural part of economic restructuring.

Surveys of small firms suggest relatively common patterns across countries (Benáček, 1995; Webster and Charap, 1994). Entrepreneurs tend to be well educated and come from the managerial ranks of state-owned enterprises, from research positions, or from the state bureaucracy. The ability to acquire access to resources from the state sector through lease, purchase or some form of legal or illegal privatization played an important role in determining who would become an entrepreneur. High taxes and heavy government regulation present serious obstacles to small businesses, although it is also quite evident that market distortions, often the result of government policy, represent valuable niches for small firms. Consequently, many small firms engage in trading rather than in production, a concern to some observers. The lack of an infrastructure of business services and communications, underdeveloped bank networks, and poor protection from corruption and crime also impose a heavier toll on small firms than on large ones.

How Much Has Been Privatized, and Who Are the New Owners?

The size of the private sector in transition economies is difficult to measure. There can be ambiguity about whether a given firm is private. For example, some countries classify state-owned enterprises that have been transformed into corporations as private, even if many (or all) of their shares are held by the government, or by government-owned banks or other state-owned enterprises. Agricultural cooperatives have often been reclassified as private, even if the reality of property relations within the individual units continues unchanged. In virtually all transition economies, the tendency is to adopt definitions that maximize the reported size of the private sector, so as to place the country's privatization and transition efforts in the best possible light. At the same time, official statistics fail to capture much of the unreported or underreported output of small private businesses and self-employed individuals. Imputed rents from owner-occupied housing that has been privatized are also understated due to past low rents and existing rent controls.

With these limitations in mind, Tables 1 and 2 present estimates of the importance of the private sector in some eastern European countries and in the former
Table 1
Privatization Results in Some Central and East European Countries, End of 1994

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of Private Sector in GDP (%)</th>
<th>Number of State-Owned Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Privatized</td>
<td>Still in State Hands</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>24</td>
<td>23</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>75–80</td>
<td>4800</td>
</tr>
<tr>
<td>Hungary</td>
<td>55</td>
<td>955</td>
</tr>
<tr>
<td>Poland</td>
<td>55</td>
<td>1308</td>
</tr>
<tr>
<td>Romania</td>
<td>35</td>
<td>600</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>40</td>
<td>800</td>
</tr>
<tr>
<td>Slovenia</td>
<td>40</td>
<td>NA</td>
</tr>
<tr>
<td>Croatia</td>
<td>40</td>
<td>2421</td>
</tr>
</tbody>
</table>

Note: While the number is by no means small, most Czech SOEs have been privatized.

Soviet Union. These numbers should be viewed with caution. Other sources provide different estimates of the size of the private sector in each country, though most estimates yield similar rankings of countries by level of privatization. In the countries where the private sector now contributes more than half of GDP, the private sector is likely to dominate retail trade, services and construction, as well as playing

Table 2
Share of Private Sector in GDP in the Former USSR, 1994

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Armenia</td>
<td>40</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>20</td>
</tr>
<tr>
<td>Belarus</td>
<td>15</td>
</tr>
<tr>
<td>Estonia</td>
<td>55</td>
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<tr>
<td>Georgia</td>
<td>20</td>
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<tr>
<td>Kazakhstan</td>
<td>20</td>
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<tr>
<td>Kyrgyzstan</td>
<td>30</td>
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<tr>
<td>Latvia</td>
<td>55</td>
</tr>
<tr>
<td>Lithuania</td>
<td>50</td>
</tr>
<tr>
<td>Moldova</td>
<td>20</td>
</tr>
<tr>
<td>Russia</td>
<td>50</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>15</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>15</td>
</tr>
<tr>
<td>Ukraine</td>
<td>30</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>20</td>
</tr>
</tbody>
</table>

a considerable role in transportation and agriculture. Moreover, in these countries, significant privatization of state-owned enterprises must have taken place, although much clearly remains to be done. In countries where the share of the private sector is no more than 30 percent, it is likely that only privatization of small firms in services, trade and construction has taken place, while much of agriculture and even more of industry remain in state hands.

The new owners of productive assets are determined in part by the extent of privatization and in part by the methods used to privatize assets. Where privatization has not progressed beyond small retail and service establishments, and perhaps agriculture, and where foreign ownership is restricted, firms are largely in the hands of owner-operators. More complex ownership patterns develop when large state-owned enterprises are privatized, and when the role of foreigners tends to expand. Table 3 gives some indication of the magnitude of foreign direct investment into some transition economies. Hungary received the largest foreign direct investment inflows, partly because Hungary’s privatization strategy stressed sales of state-owned enterprises to foreigners and partly because foreign investors had a positive view of Hungary. Countries that have failed to pursue privatization aggressively or that are perceived as not pursuing effective economic policies have had very small capital inflows. Russia, in particular, would rate much worse in the foreign direct investment/GDP measure if its GDP were converted to dollars using a more realistic purchasing power parity exchange rate.

Despite the relatively low ratio of cumulated foreign direct investment to GDP in the transition economies, foreign owners are often quite visible because they appear in large transactions involving the purchase of well-known local firms. The sale of part ownership in the Hungarian and Czech telecommunications companies accounted for nearly $2 billion in foreign direct investment; Volkswagen’s purchase of Czech automaker Skoda and Fiat’s and Daewoo’s purchases of Polish automobile factories exceed this amount. Moreover, foreign investors often leverage their investments by buying only enough shares to gain control of firms. In Hungary, only a third of firms with foreign owners are totally foreign owned; for the others, the ownership share of foreign investors is only slightly over 50 percent (OECD, 1995b, pp. 82–83).

The pattern of indigenous ownership of former state-owned enterprises depends on the method of privatization. For example, the voucher method creates individual shareholders, although their nature differs considerably. In the Czech Republic, individual shareholders tend to be outsiders; in Russia, insiders, both managers and workers. Voucher privatization also created the Investment Privatization Funds, another category of owners. In the Czech Republic, all but one of the major IPFs are owned by banks, giving banks a key role in ownership of large Czech firms. In Russia, at the other extreme, IPFs have a smaller share of outstanding vouchers, and there is less bank ownership.

In most transition economies, the state continues to be an important owner of certain firms or of entire sectors of industry. Even when many shares are sold to investors or distributed through mass privatization, the state often retains a block
Table 3
Gross Foreign Investment in Transition Economies
(as of September 1994)

<table>
<thead>
<tr>
<th></th>
<th>Foreign Direct Investment (million $)</th>
<th>GDP (billion $)*</th>
<th>Foreign Direct Investment/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>1534</td>
<td>10.0</td>
<td>.015</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2,699</td>
<td>34.8</td>
<td>.078</td>
</tr>
<tr>
<td>Hungary</td>
<td>6,458</td>
<td>40.7</td>
<td>.159</td>
</tr>
<tr>
<td>Poland</td>
<td>1,3694</td>
<td>108.3</td>
<td>.013</td>
</tr>
<tr>
<td>Romania</td>
<td>3711</td>
<td>11.4</td>
<td>.032</td>
</tr>
<tr>
<td>Russia</td>
<td>3,606</td>
<td>174.1</td>
<td>.021</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>3681</td>
<td>12.4</td>
<td>.030</td>
</tr>
</tbody>
</table>

* At the official exchange rate.
4 Net FDI.
1 1993.


of shares, sometimes remaining the largest shareholder in the firm. These shares are held either by ministries or by specialized national property management funds or agencies (Mihályi, 1994a). Some agencies have adopted a passive attitude toward corporate governance; others have exercised strong influence over managers (Pistor and Turkewitz, 1994). The pattern of ownership emerging in the transition economies is thus a dualistic one. A group of small proprietors, joined in some countries by private farmers, has emerged quite quickly. However, ownership of large firms remains relatively concentrated among insiders, institutional holders and the state. The next section examines how this shift in ownership of large firms has affected corporate governance.

Corporate Governance and Privatization

Corporate Behavior in the Early Transition

In the early 1990s, many observers argued that the state-owned enterprises that dominated industry in these countries could not be reformed save through privatization (Kornai, 1990; Lipton and Sachs, 1990; Aghion, Blanchard and Burgess, 1994). This negative prognosis has held true in some countries of the region. But in other economies, especially in former Czechoslovakia, Hungary and Poland, after some initial hesitation, many state-owned enterprises have responded quite flexibly, more or less along the lines expected of firms whose managers are fulfilling the objectives of wealth-maximizing owners. The evidence for this claim comes from an accumulating body of evidence based on surveys of firms in these countries. It includes studies of Hungarian firms by Brada, Singh and Török (1994); of

These authors find that managers have undertaken short-term adjustments in output and input levels that are broadly consistent with what would be expected of profit-maximizing firms. Output, employment and capacity have been reduced to reflect market demand. New marketing channels and export markets have been developed. Managers have attempted to reduce operating costs and exposure to bad debts. There has been no wholesale decapitalization of firms. In general, firms with positive profits tended to invest or to reduce debt. Neither managerial incomes nor the wage bills of state-owned enterprises have grown disproportionately; in many firms, labor costs have decreased as a share of total costs.

Moreover, firms have begun to formulate long-term strategies for survival and expansion. Most notably in Czechoslovakia, large state-owned enterprises were broken up into constituent parts, with each then free to follow its own business strategy. In Hungary, many managers restructured multiunit state-owned enterprises into a holding company and affiliates. The debts were concentrated in the holding company, and available resources were concentrated on the affiliates with the greatest potential for survival. Major changes in product mix were introduced, often in strategic partnership with foreign firms. These strategic changes were more evident in Czechoslovakia and Hungary, where power was in the hands of managers, than in Poland, where workers' councils limited managerial autonomy (Estrin et al., 1995; Estrin, Gelb and Singh, 1995). Nevertheless, Pinto and his collaborators cited above make a strong argument that long-term adjustments were not uncommon among Polish state-owned enterprises.

Given the earlier beliefs that privatization was a necessity, the tenor of these adjustments is somewhat surprising. A possible explanation is that the creation of a hard budget constraint and restrictions on credit for the enterprise sector, along with functioning markets, competition and bankruptcy laws, introduced an indirect, yet effective, form of corporate governance that had been lacking in the centrally planned economies. Foreign competition, brought on by trade liberalization and the introduction of convertibility also introduced an important element of competition; Brada and Singh (1994) document the upsurge in foreign competition encountered by Polish state-owned enterprises between 1989 and 1993.

In this new economy, both workers and managers understood that decapitalizing their enterprise would lead to its eventual demise. In the face of high and persistent unemployment, even workers who were united in powerful councils have chosen long-term job security over high wages that could decapitalize and kill off the firm. Managers facing a job market no longer based on political favoritism realized that driving their present firms into bankruptcy was not a springboard for success in the developing market for managerial talent (Pinto, 1995).

5 For a critical view of this process, see Lízl, Singer and Svejnar (1995).
6 See Stark (1996) for the emergence of cross-ownership by Hungarian firms.
Managers of firms facing a credible prospect privatization often worked hard to make their firm attractive to future owners: Brada, Singh and Török (1994) describe this phenomenon in Hungary; Estrin, Gelb and Singh (1995) offer evidence for Czechoslovakia and Hungary; Estrin, Gelb and Singh, along with Pinto (1995, p. 25), report a similar if somewhat weaker response in Poland. Of course, managers are more likely to take this approach if the economic environment is such that potential owners have some confidence that there is a close relationship between managerial effort and enterprise performance. Thus the rationality of prices, the absence of government controls and subsidies, the existence of competition from domestic or foreign sources, and macroeconomic stability all serve as important underpinnings for encouraging managers to focus on productive behavior rather than engaging in self-serving behavior that is harmful to the interests of the firm.

What Sort of Private Ownership is Being Created?

While the prospect of privatization, made in the context of hardening budget constraints and a more rational business environment, may stimulate managers of state-owned enterprises, the prospect of each firm's privatization can be made credible only if the privatization program is eventually carried through. Then the owners of the newly privatized firms must take over control. Whether the capacity to exercise effective control over their firms exists and is being applied to firms in transition economies is a difficult but important issue.

One straightforward option might seem to be to look at the relative performance of privatized and unprivatized firms, but this approach is subject to serious biases. In Hungary, the better state-owned enterprises were privatized first. In Poland, some state-owned enterprises were privatized through liquidation: that is, they were sold off because they were not viable under state ownership. Given the evidence on restructuring by state-owned enterprises above and the short period in which private owners (including foreign investors) have been on the job, systematic differences between privatized and unprivatized state-owned enterprises are difficult to uncover. Moreover, measures intended to restore long-term viability may require large losses in the short term. Compared to the state-owned enterprises, newly started private firms do seem to offer higher job creation, profitability, growth and the absence of overstaffing, but this may reflect the fact that most of them were formed after the large output declines of the early transition period, and thus their productive capacity reflected current market conditions from the start.

The abilities of new owners matter because if privatization fails to provide effective corporate governance, then measures of the extent of privatization such as presented in Tables 1 and 2 will have to be rethought, because transition economies would not be moving toward capitalist systems in the sense that we think of them, but rather toward some form of nonstate socialism or an eastern European corporatism. Whether effective corporate governance is being created for former state-owned enterprises rests on whether it is possible for new outside owners to monitor and discipline managers effectively and whether new owners have the ability and
motivation to do so. This depends very much on the country and on the means of privatization adopted.

In Hungary, case studies show quite clearly that foreign investors involved in the privatization of state-owned enterprises are exercising their rights to determine corporate policies (Carlin, van Reenen and Wolfe, 1994; Estrin et al., 1995). Some domestic owners who have either founded or gained control of large firms are exercising the kind of control that large shareholders do in developed market economies.7 Nevertheless, this represents a very small proportion of cases.

In Russia, prospects of outsider control of privatized enterprises are dim in the near term and doubtful in the long term. Perhaps eventually the dispersion of insiders’ shares will lead to the emergence of activist outside owners who will wrest control from entrenched insiders (Shleifer and Vasiliev, 1994), but the current situation reflects the fact that privatization of state-owned enterprises was based on the political decision to cede control to insiders. Much the same can be said for other countries whose privatization split ownership between insiders and a passive national property fund.

In the Czech Republic, through the decisions of voucher holders, about 70 percent of the shares of privatized state-owned enterprises went to Investment Privatization Funds (IPFs).8 Because the funds were usually founded by banks, they have leverage over firms not only by virtue of ownership but also by virtue of the banking relationship between their parent banks and the firms whose shares they hold. Of course, leverage works both ways, and an IPF’s ownership decisions must take into account their implications for the bank’s loan portfolio. Coffee (1994) reports that IPFs have little difficulty in getting representation on boards of directors and that boards have significant powers, but many knowledgeable observers are skeptical of the role that IPFs are able to play in the governance of privatized state-owned enterprises. Most IPFs have portfolios containing hundreds of firms, and finding individuals to represent the funds on boards is difficult and expensive. Coffee reports that directors representing IPFs have little knowledge of the firms on whose boards they sit, or of business affairs more generally, and thus are unable to exert much discipline on managers.

The slowness of Czech IPFs to restructure the firms whose shares they own may stem from the funds’ ties to their parent commercial banks. Perhaps rather than pushing for share price maximization, the banks may view their IPF’s ownership of a firm’s shares and participation on its board as a way of increasing the bank’s financial transactions with the firm, of protecting the bank’s loans to the firm, and of obtaining additional information about the firm. If so, a similar issue of fund

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7 For example, in Hungary, a private firm, Muszertechnica, has taken over a large state-owned enterprise in the process of privatization; in Russia, Mikroin has succeeded in imposing itself on privatized enterprise that was formerly state-owned (Shleifer and Vasiliev, 1994).

8 This is in marked contrast to the Russian case where outsiders have difficulty in gaining representation on boards and where board powers are relatively circumscribed (Pistor, Frydman and Rapaczynski, 1994).
governance will arise in the Polish case, where the boards of the funds consist of public appointees.

There were expectations in both the Czech and the Polish voucher privatizations that the stock market would also act as a mechanism for evaluating the performance of firms and thus disciplining managers. But with large insider and institutional holdings, the stock markets have been very thin. In practical terms, they have so far not offered a strong source of influence on managers (Triska, 1995). A popular perception is that, in many transition economies, it is the banks that are emerging, or perhaps should emerge, as the major players in corporate governance, somewhat like the German or Japanese model where banks are connected to firms by ties based both on loans and on ownership of the firms’ shares by the bank. The advantages of this system are seen as the superior information available to banks by virtue of their dual role as creditors and owners, their skills in processing financial information, and their willingness to accept firms’ pursuit of long-term strategies at the expense of short-term gains in profits (Aoki, 1995; Litwack, 1995).

Whatever the virtues of this system in Japan and Germany, it is uncertain how well they apply in the situation of the transition economies. In some countries, the major commercial banks remain state-owned, or the government retains a major ownership role. Where the large commercial banks are more free of government control, it is nonetheless true that they were often organized out of the communist-era state banks and assigned clients, with their assets and liabilities, in arbitrary fashion. Some observers have argued that such a banking system was not only incapable of exercising effective governance over clients, but that it also tended to perpetuate the defects in corporate governance that existed prior to the start of transition (Phelps et al., 1993, pp. 25–28). The arbitrary assignment of clients and lack of effective bankruptcy legislation made such banks captive to their creditors, forcing them to continue to lend to poorly performing firms.

The evidence on how banks have behaved in transition economies is mixed. Dittus (1994) argues that banks in the region have, in aggregate terms, redirected credit from badly to well-performing firms. Čapek (1995) shows that, in the case of Czech banks, the portfolios of newly formed and foreign-owned banks differ from those of the large commercial banks founded at the start of the transition in a way that suggests that the newcomers are much less the captives of past credit relationships. Nevertheless, the evidence of bank activism in restructuring poorly performing firms does not suggest that banks are a major instrument of corporate restructuring (Groszek, 1995; Litwack, 1995). The reasons are clear, and similar to those already raised in the case of investment funds. Monitoring and activism are costly, the ownership structure of banks may not be conducive to activism in restructuring, and government policies may even discourage restructuring activities by banks.

Finally, the government remains as a large shareholder both in the many unprivatized state-owned enterprises in transition economies, and also in the privatized ones. Often, government ownership is passive. In large part this is a policy choice, but it is unlikely that governments can play an active role in
corporate governance. Like the banks and investment funds, they lack the human resources needed for effective representation on corporate boards. In fact, civil servants are often prohibited from receiving director’s fees, and with no reduction of their normal duties and no compensation to boot, they are likely to play a passive role even if they were to have the requisite business knowledge.

In sum, the creation of effective corporate governance of formerly state-owned enterprises is incomplete and its future is uncertain. Nevertheless, the magnitude of the problem is difficult to judge. After all, insiders are often entrenched even in market economies, where shareholder activism in dislodging top-level executives is seen as a newsworthy event. Thus the alleged passivity of the new owners in transition economies needs to be placed in perspective. Perhaps, given the relatively turbulent environment in transition economies and the need for managers to establish a track record in a market environment, such seeming passivity may be in the best interest of owners and society alike.

**Key Lessons**

The experience of privatization in transition economies offers two main lessons so far: one involving the means of privatization, the other with interpretation of the outcomes. First, it is evident that grand designs for privatization cannot be drawn up, and any country wishing to make significant progress in privatization must employ a broad range of methods. For example, unless countries are willing to try a giveaway method of mass privatization, they will find it very difficult to privatize the majority of state-owned enterprises. The second lesson is that, in many cases, assets may be privatized, but control by new owners who are outsiders is difficult to achieve. Thus a dual structure of small private businesses and large foreign-owned firms whose governance resembles that observed in developed market economies coexists with former state-owned enterprises whose governance structure remains quite unclear.

The question in the title of this paper—whether privatization is identical to transition—is thus two-fold. First, formal measures of how many state-owned firms are privatized or of the share of the "private" sector in the economy may convey misleading information about the progress of system change because formal or *de jure* privatization may not create the outside owners or effective corporate governance that we associate with capitalism in developed market economies. On the other hand, excessive emphasis on privatization may blind us to the fact that the liberalization of markets, the hardening of budget constraints and macroeconomic stabilization have much to do with the efficiency of resource allocation and the effective governance of firms and that less than total privatization may, nevertheless, lead to considerable changes in the way transition economies function.
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References


