EC330-3-SP – Lecture 10

Privatisation: Varieties of Experience

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Plan of talk

- **Introduction**

1. Privatisation during transition: stylised facts
2. Privatisation during transition: country cases
    1. Mass privatisation
        1. To Outsiders: Czech Republic
        2. To Insiders: Russia
    2. Privatisation through sales
        1. Top-down: East Germany
        2. Bottom-up: Hungary, Poland
3. Privatisation during transition: were the objectives achieved?

- **Wrap-up**

Aim and learning outcomes

- **aim**: compare the experience of transition economies with privatisation policies
- **learning outcomes**
  - discuss the commonly observed facts about privatisation
  - evaluate the costs and benefits of the principal types of privatisation as evidenced in various country cases
    - mass privatisation to outsiders
    - mass privatisation to insiders
    - top-down privatisation through sales
    - bottom-up privatisation through (noncash) sales

Privatisation policies in Eastern Europe

- **large-scale privatisation** in former *socialist* countries
  - historically unprecedented experience
  - no ready recipes existed
- initially, attempts to adapt *UK* experience under Thatcher

  commercialisation = reassertion of state property rights over enterprises and a centralised policy of *sales* following a process of valuation
- then, **mass privatisation** in fashion for some time
- transition privatisation experience was, in fact, a *combination* of
  - direct sales
  - management buyout
  - and vouchers

  particular to any of the countries
- **similarities** in the broad approaches can nevertheless be found

Stylised facts

- Table 10.1, p. 231 in Roland (2000)

  provides a rough **classification** of the main policies followed by the earliest reformers

- Table 10.2, p. 232 in Roland (2000)

  compares estimates for the evolution of the share of the **private sector in GDP**

- Table 10.3, p. 233 in Roland (2000)

  revenues from the privatisation process have turned out to be far below initial expectations

Mass privatisation to outsiders: the case of the Czech Republic (I)

- for a fee of 1000 koruny any citizen over 18 could purchase a **booklet of vouchers** worth 1000 points with which to bid for shares of firms being privatised
  - *book value* of the counterpart of such booklet evaluated at 80000+ koruny
  - law *prevented* investment funds from holding 20+% of shares in a firm
- privatisation to outsiders is considered a **better method** than privatisation to insiders in
  - replacing incompetent managers and
  - achieving efficient matching of skills to privatised assets
- not true if privatisation results in **dispersed ownership**
  - *free-rider problem*: small shareholders do not have incentives to bear the costs of collective action but benefit from its outcomes
  - thus, *insufficient monitoring* of incumbent managers

Mass privatisation to outsiders: the case of the Czech Republic (II)

- managers understood well the effects of **dispersed ownership**
  - before the 1st wave of mass privatisation, they were given the opportunity to submit privatisation projects
    - incumbent managers tended to favour privatisation of their firm through the voucher programme
    - expecting that dispersed ownership would leave them in control
  - among the enterprises participating in the 1st wave, 85% of the privatisation projects approved by the Ministry of Privatisation have been submitted by managers
- the objective of giving managers incentives to engage in **defensive restructuring** is partly achieved
  - managers who have low costs of defensive restructuring benefit from signalling themselves to potential investors
  - who, in turn, would be more inclined to bring in fresh capital once restructuring has already started

Mass privatisation to outsiders: the case of the Czech Republic (III)

- Czech programme has turned out to be **disappointing**
- *corporate governance structure* that came out was **“incestuous”**
  - most *investment funds* were founded by banks that were to be privatised through vouchers
  - in result, *banks* were privatised to investment funds that belonged to banks
- this practice resulted in **full insider control**
- moreover, due to inadequacies in the legal and regulatory framework, all sorts of **asset stripping** emerged

Mass privatisation to insiders: the case of Russia

- by **contrast** to the Czech case, Russian citizens were allowed to sell for cash the shares acquired through vouchers
- but **neither** mass privatisation strategy provides a mechanism for replacing incompetent management
  - in the Russian case, the latter receive ownership directly
  - in the Czech case, no strong outside control due to dispersed ownership
- **both** giveaway schemes
  - tend to favour insider entrenchment of managers of profitable firms
  - provide insufficient outside finance…
  - … and, hence, incentives only for defensive restructuring
  - address ex-ante political constraints of restructuring
  - yet, violate the fiscal constraint => the ensuing loss of governmental wealth has had disastrous consequences for *macroeconomic stability* in Russia
    - a weak state cannot protect property rights
    - powerful industrial groups controlled by insiders block efficient tax collection

Top-down sales to outsiders: the case of East Germany

- from **allocative efficiency** viewpoint, the more competitive the process of privatisation, the less important the role of informational constraints
- auctions also lead more naturally to **strategic restructuring**, since buyers are willing to put up the funds necessary for new investment
- but the **stock-flow constraint** poses a *dilemma* for the government:
  - *either* **phase down** privatisation so as to ensure that a fraction of the available stock of assets is offered for sale to the annual flow of savings for each year, thus hoping for higher revenues but slower transfer of ownership
  - *or* **speed up** the process at the cost of much lower sale prices, resulting ultimately in a fall in budget revenues
- the latter choice was preferred in East Germany => **fiscal strain**
- **administrative constraints** are particularly important:
  - a staff of 3000 employees at the *Treuhandanstalt* alone!
  - Poland’s Ministry for Ownership Changes had 200 employees
  - Hungary’s State Privatisation Agency only 140

Gradual bottom-up sales to outsiders: the case of Hungary and Poland

- several **potential buyers**, insiders or outside investors, **signal** their **interest** in purchasing a firm
- then, **gradual sales**
  - not because of a limit in the supply of privatisable assets
  - but due to a limit in their demand
    - not related to limited private domestic wealth, since sales to domestic buyers took mostly the form of sales against noncash bids, such as
      - leasing
      - partial purchases
      - payment by instalments
      - purchase against future payments associated with debt contracts
    - a more likely reason for the low demand for privatisable assets may thus have been the asymmetric information about the quality of
      - the firm's assets
      - the incumbent management
- (foreign) private investors prefer firms where the **quality of assets and management** yields more promising expected returns

Transition experience with privatisation: were the objectives achieved?

- hard to say precisely which of the objectives, and to what extent, have been achieved by the **various forms of privatisation**
- a **summary of their effects**, based on the country experience we discussed, is provided in Table 10.4, p. 249, Roland (2000)
- most important **conclusions** seem to be the following
  - all forms of privatisation have changed *managerial and workers' incentives*, by relating them more closely to effort and performance
  - inducing *strategic restructuring* has been a problem, especially for mass privatisation
  - mass privatisation to insiders has been a particular case of *stuck reforms*
  - as for generating *financial resources in the government budget*, mass privatisation has not been successful either
  - but even privatisation through sales has brought modest revenues, mostly due to
    - rather outdated plants (and machines) offered for sale
    - partial asset stripping
    - various schemes of noncash payments, imposed by the stock-flow constraint
    - overall uncertainty during transition and fears of investors about reversals

Concluding wrap-up

- **What have we learnt?**
  - how similar/different country-by-country experience with privatisation during transition have been
  - which the principal pros and cons of each of the main strategies are
  - what the overall outcome of privatisation in Eastern Europe has been
- **Where we go next**: to the analysis of *corporate governance*: the further, and more fundamental objective, of post-socialist privatisation