DISCUSSION PAPER SERIES

No. 544

PRIVATIZATION IN HUNGARY, POLAND AND CZECHOSLOVAKIA

Irena Grosfeld and Paul G Hare

AM

Centre for Economic Policy Research

www.cepr.org

Available online at: **www.cepr.org/pubs/dps/DP544.asp**

ISSN 0265-8003

PRIVATIZATION IN HUNGARY, POLAND AND CZECHOSLOVAKIA

Irena Grosfeld, DELTA, Paris and SITE, Stockholm School of Economics and CEPR
Paul G Hare, Heriot-Watt University

Discussion Paper No. 544
April 1991

Centre for Economic Policy Research
90–98 Goswell Rd, London EC1V 7RR, UK
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999
Email: cepr@cepr.org, Website: www.cepr.org

CEPR Discussion Paper No. 544

April 1991

ABSTRACT

Privatization in Hungary, Poland and Czechoslovakia*

Several East European countries are embarking on major programmes both to expand their private sectors by encouraging new firm formation, and to transfer much of the existing state sector into private ownership. This paper studies the early experience of Hungary, Poland and Czechoslovakia in these areas, and reviews in detail their privatization plans for the three years 1991-3. All three countries envisage that about half the existing state sector will be in private hands by 1994 an extremely rapid rate of ownership change. While all countries will use a mixture of privatization methods, Hungary intends to sell its state firms, while the other two countries will also give away to the population a substantial fraction of the shares in the largest firms. Both approaches involve some very difficult problems. In the case of sales, it is uncertain how rapidly these can take place if a 'reasonable' share price is to be maintained. In the case of giving away shares, which in practice requires some important institutional developments such as the creation of Privatization Funds (as suggested in Poland), the main difficulty is likely to be associated with the sheer administrative complexity of the privatization process.

JEL Classification: 123
Keywords: auctions, eastern europe, financial institutions, ownership and privatization

Irena Grosfeld
DELTA
ENS
48 Boulevard Jourdan
75014 Paris
FRANCE
Tel: (33 1) 4313 6328
Fax: (33 1) 4313 6310
Email: grosfeld@delta.ens.fr

Paul G Hare
School of Management
Heriot-Watt University
Riccarton
Edinburgh
EH14 4AS
Tel: (44 131) 451 3483
Fax: (44 131) 451 3498
Email: p.g.hare@hw.ac.uk

*This paper is produced under the auspices of the CEPR research programme on Economic Transformation in Eastern Europe, supported by grants from the Commission of the European Communities and the Ford Foundation. Publication of this paper is supported by the Commission of the European Communities under its SPES Programme (no. E/90100033/PRO).

Submitted 20 March 1991

1. Introduction: the main issues

After the excitement of 1989 and early 1990, with the collapse of the old communist regimes and their replacement with elected, non-communist governments, it is understandable that in the second half of 1990 there should have been a feeling of disappointment at the apparent lack of real change in Eastern Europe, especially at the microeconomic level. Privatization has proceeded more slowly than many outside observers hoped or expected, but this can be attributed partly to the need for new governments to settle in and establish their policies, partly to the sheer complexity of economy-wide privatization and the need to prepare for it carefully, and partly to wider concerns (especially among politicians and professional groups, to a lesser extent in the population at large) resulting from the so-called 'wild' or uncontrolled privatization that occurred in Hungary and Poland in 1989 and early 1990 (see Grosfeld, 1990; Hare, 1990). A further possible reason for delay by the new governments was their initial expectation that substantial aid might be forthcoming from the West, including debt relief for Hungary and Poland, along the lines of a new Marshall Plan for the East. On the other hand, now that both domestic policies and the likely scale of western aid are becoming clearer, it can be argued that privatization must be quite rapid in order to forestall a continuation of uncontrolled initiatives, as we discuss further below.

In the three countries studied in this paper, Hungary, Poland and Czechoslovakia (CSFR), there has been substantial change, at least in the form of active preparation for programmes of rapid privatization to be implemented over the next two to three years. By the end of 1990, all three countries had more or less detailed privatization plans in place covering both the major State enterprises and smaller businesses. These programmes are fully reviewed in Sections 3, 4 and 5 below. From these sections it will be apparent that the level of understanding about privatization, and the realism and clarity of the individual countries' programmes, still differed significantly. Section 2 summarizes available information on the extent of the private sector in each country. This is important from several points of view: creating a market-type environment and assessing the familiarity of managers with operating in such an environment, especially in responding to competition; providing a source of potential managers at various levels; spreading knowledge about the role and functioning of markets in the general population of each country. The final section of the paper draws out some important policy issues which could be applied more widely in the region.

In the remainder of this introductory section, we briefly review some of the main issues facing the architects of privatization programmes in Eastern Europe as these have emerged through theoretical discussions, concrete privatization models and proposals, and the limited practical experience that has been gained to date.

We shall take it for granted that privatization is desirable. In the East European context privatization should be seen indeed as the fundamental element in the process of creating a competitive market environment (see Grosfeld, 1991), and not only as a way of improving the performance of some State-owned enterprises. Hence one should not discuss the process as if it were merely a somewhat larger version of, for example, the UK's privatization programme, since that took place in an already established market environment, complete with all the required supporting institutions and infrastructure.

On the other hand, the lack of a market environment, which is a strong argument for privatization, is at the same time an obstacle to it. The virtual absence of well-established and functioning financial markets, and the lack of an established and well-understood legal and regulatory framework require great care to be taken in determining the place of privatization in the sequence of new policies. Security of private property, with its associated legal rights, responsibilities and liabilities, is an essential first step. In addition, it is important to establish the key financial markets, at least to a rudimentary level. Finally, anti-monopoly policy (which may entail breaking up larger firms into smaller units), domestic price liberalization, import liberalization, and reforms of the tax system can all be expected to influence enterprise behaviour.

Even though ownership change alone might appear to change very little, the recognition of owners other than the State is an important step towards a market economy. And once these new owners acquire rights which can be protected in the courts, the old system of State 'tutelage' will become increasingly unsustainable. Thus whether or not privatization succeeds in delivering immediate productivity gains, it has to be seen as an important means of breaking down the traditional State structures of the old-style planned economy. And these structures will not just go away by themselves.

If we accept that extensive privatization must form part of any serious reform programme (which is recognized by almost everyone with influence over economic policy in the region), there are several critical decisions to be taken, including:

(a) Scope of the programme: this allows for different sectors to be treated in different ways and also allows some sectors to be excluded altogether. Different types or sizes of enterprise can be treated differently.

(b) Speed of implementation: again, this may vary according to the sector and/or size of enterprise. The approach taken here also depends on views about appropriate sequencing, such as the proper ordering of import and price liberalization, demonopolization, and privatization itself. It may also reflect a political judgment that rapid privatization is essential in order to maintain the momentum of a reform programme, along with the popular support for it. On the other hand, there are arguments that the government is responsible for the national wealth and should not sell it or give it away before it is carefully valued and proper owners are found. This is linked to the following point.

(c) The degree of institutional engineering: some new institutions will have to be created whatever the speed and the programme of privatization (e.g. development of suitable financial intermediaries), but a decision must be taken on whether it is possible to rely on an organic development of these institutions, or whether more 'revolutionary' approaches are required. In the latter case, the extent of active construction of new institutions also has to be decided.

(d) Method(s) of privatization: many possibilities have been proposed in the recent literature, and some of the more interesting ones relevant for the countries studied here are reviewed in the following sections.

(e) The degree of order in the privatization process, the extent to which it is supervised by the State authorities or left to spontaneous forces on the basis of general enabling legislation. The key issues here are whether the administration of a privatization programme should be highly centralized, or decentralized to a variety of lower-level bodies; and in either case, whether the process should be controlled, or relatively uncontrolled.[1] As we shall see, all three countries under study here have chosen relatively controlled approaches, but with differing degrees of decentralization.

(f) The question of whether or not there should be any restrictions on who the new owners of privatized firms can be (this issue obviously relates to points (c), (d) and (e) too).

(g) The extent to which State preferences are reflected in the privatization programme. For example, this could take the form of the initial selection of sectors (or even individual firms) on which the programme would focus, privileges to foreign investors (or other investors) in certain branches, tax or credit favours for certain firms or types of firm, and so on. It is important both to assess whether such preferences exist and to evaluate their likely efficacy and economic desirability.

(h) The extent to which there should be restitution to former owners. This could take the form of a physical return of the assets concerned, or financial compensation for their original alienation by the State.

(i) How to manage what remains of the State sector. As explained below, it is apparent that the State sector will remain large for several years, even with rapid privatization. Hence improvements in its efficiency will exert a strong effect on the overall performance of these economies.

(j) Finally, the extent and form of social protection associated with a privatization programme. All countries recognize that one effect of their reforms will be the shedding of labour by those firms capable of continuing in production, and the complete closure of many others. Hence it is to be expected that the social and political acceptability of privatization will depend on the social protection of incomes (e.g. through unemployment benefit), and on arrangements for retraining redundant workers. This is an extremely important issue, but it receives only very brief treatment below, for reasons of space.

2. Private sector activity in Hungary, Poland and Czechoslovakia

This section provides some tentative estimates of the scope of private-sector activity in each country, and also reviews certain measures other than privatization itself, such as Hungary's new bankruptcy law, which are designed to make the State sector behave more competitively. Ideally, a fuller account of the policy and institutional background in each country should be provided here, since their experience and progress towards a market economy was very different in the 1980s, and the new measures adopted in 1989 and 1990 have also differed significantly among countries. Unfortunately, lack of space prevents us from giving a detailed survey. For all three countries, data on the private sector are rather poor, but those cited below do at least give an indication of current trends.

[1] It has been argued, for instance, that the attempt by the State to control these processes in Poland and Hungary in 1990 has effectively slowed down privatization, and that this was initially quite damaging to the credibility of both countries' reforms. On the other hand, whether the implementation of programmes is decentralized or not, control is clearly important to prevent an effective takeover of each economy by those in a position to accumulate the necessary funds: this includes crooks, ex-members of the *nomenklatura*, and foreigners. From a moral point of view, the last group is obviously not in the same category as the others, but although foreign capital is welcomed in Eastern Europe, there would certainly be political concern if the share of foreign ownership became too high.

2.1. Hungary

For Hungary, which started to encourage small firms a decade ago, it is useful to examine changes in the size structure of firms in the economy since the new enterprise law came into effect at the beginning of 1989, the extent of the private sector, and the extent of privatization to late 1990. From 1988 up to September 1990, the number of economic organizations grew by almost two-and-a-half times. Limited liability companies showed the fastest growth, while the number of traditional companies and cooperatives was almost unchanged. As Table 1 indicates, the most dramatic changes came in the areas of foreign trade, domestic trade and transport. A very similar pattern can be seen if we study changes in the numbers of economic organizations classified by size: the number of units employing fewer than 20 persons increased fastest, with limited companies again providing the main legal form. The result is a very marked change in the size structure of Hungarian firms, as indicated in Table 2.

While the large number of new start-ups is a very positive feature of the Hungarian economic situation, the slow rate of bankruptcy or liquidation is not. From January to September 1990, only 1,5% of economic organizations failed, and over half of these employed fewer than 50 people (see Table 3). Thus the termination of unprofitable activities, although commoner than in the past, is still a rarity (in industry alone about 300 of the State-owned companies were on the verge of insolvency in summer 1990). Moreover, the usual feature of market economies, whereby many new firms fail in their early years, is not yet much in evidence in Hungary.

Table 1

Number of economic organizations in Hungary by national economic branch and organizational form, 1988-90

	Company			Economic partnership			Of which: Ltd			Of which: joint-stock company		
	1988	1989	1990	1988	1989	1990	1988	1989	1990	1988	1989	1990
Industry	1 014	1 038	1 028	280	1 486	4 318	176	1 296	4 051	39	125	206
Building industry	265	259	247	115	740	2 358	50	663	2 266	3	17	45
Agriculture	159	158	172	70	177	481	4	104	389	1	3	16
Transport-communication	60	63	71	11	145	530	8	140	518	1	3	6
Home trade	325	324	313	145	1 273	4 660	78	146	4 468	18	60	122
Foreign trade	60	58	53	40	266	965	13	223	906	5	21	44
Other service	495	501	497	292	1 136	3 302	121	1 912	2 962	49	78	156
Total	2 378	2 401	2 381	953	5 223	16 614	450	4 484	15 560	116	307	595

	Of which: limited partnership			Cooperative			Other[1]			Total		
	1988	1989	1990	1988	1989	1990	1988	1989	1990	1988	1989	1990
Industry	1	—	—	1 545	1 568	1 556	—	—	—	2 839	4 092	6 902
Building industry	4	4	—	1 206	1 294	1 299	—	—	—	1 586	2 293	3 904
Agriculture	1	1	1	1 335	1 349	1 392	—	—	—	1 564	1 684	2 045
Transport-communication	1	1	1	76	83	79	—	—	—	147	291	680
Home trade	1	1	1	409	428	455	—	—	—	879	2 025	5 428
Foreign trade	6	2	2	—	1	—	—	—	—	100	325	1 021
Other service	20	23	5	2 309	2 353	2 358	600	536	565	3 696	4 526	6 722
Total	34	32	10	6 880	7 076	7 142	600	536	565	10 811	15 234	26 702

1988-89: status at 31 December.
1990: status at 30 September.
[1] The majority of this category are water management associations.
Source: Data supplied by the KSH (unpublished).

Table 2

Number of economic organizations in Hungary by employment category and organizational form

	< 20 pers.			21-50 pers.			51-300 pers.	
	1988	1989	1990	1988	1989	1990	1988	1989
Company	95	97	104	139	137	159	693	712
Economic partnership	367	3 441	12 277	200	937	2 518	254	628
Of which: Ltd	256	3 266	11 960	96	799	2 322	67	366
Of which: joint-stock company	32	66	135	21	51	108	29	90
Of which: limited partnership	12	12	3	12	11	4	6	5
Cooperative	1 090	1 156	1 251	1 178	1 265	1 127	2 028	2 047
Association	462	402	428	1	1	1	64	64
Other	9	9	12	42	47	51	9	9
Total	2 023	5 105	14 072	1 565	2 387	3 856	3 048	3 460

	Over 301			No data supplied			Total	
	1988	1989	1990	1988	1989	1990	1988	1989
Company	1 140	1 143	1 372	11	12	21	2 378	2 401
Economic partnership	99	189	314	33	28	38	953	5 223
Of which: Ltd	5	33	110	26	20	24	450	4 484
Of which: joint-stock company	34	99	169	—	1	1	116	307
Of which: limited partnership	1	1	—	3	3	2	34	32
Cooperative	983	983	891	1 601	1 625	1 753	6 880	7 076
Association	1	1	—	6	2	4	534	470
Other	1	1	1	—	—	—	64	66
Total	2 524	2 617	2 578	1 651	1 667	1 816	10 811	15 236

1988-89: status at 31 December.
1990: status at 30 September.
Source: Data supplied by the KSH (unpublished).

Table 3

Changes in the distribution of enterprise size in Hungary, 1988-90

Year	Number of employees				
	1-20	21-50	51-300	301+	Unspecified
1988	18,7	14,5	28,2	23,3	15,3
1989	33,5	15,7	22,7	17,2	10,9
1990	52,7	14,4	16,4	9,7	6,8

Source: Calculated from Statistical Office data.
Note: All figures are percentages of the number of economic units operating in the given year. For 1988 and 1989, data refer to the situation as at 31 December, while for 1990 was 30 September.

It is worth adding, however, that a new bankruptcy law has been prepared (see Szantó, 1990; Mora, 1990). On being declared bankrupt, either at its own request or that of creditors, a company gains three months (during which period only wages have to be paid) in which to devise a reorganization plan acceptable to its creditors, failing which the courts can enforce liquidation. It remains to be seen whether creditors, in the present uncertain business climate, will feel able to press their claims and enforce closures as required. The problem is that by pressing their claims, they may find that their debts simply have to be written off. Nevertheless, if they do so act, then the new law should help to remove the so-called queueing problem, whereby enterprises were effectively forced to grant each other undesired trade credit in order to keep going (this problem is also being addressed by sharp rises in interest rates on inter-enterprise loans, and by related financial measures operated by the banks).

If assets have to be sold to repay creditors, then the costs of the liquidation are covered first, along with wages owed to employees, then taxes and other contributions to the State, then payments for public utilities, and finally the ordinary creditors. Any remaining funds after everyone has been paid go to the owner(s) of a private company, or to the State Property Agency in the case of a State-owned firm. The new law, which came into effect at the start of 1991, also provides for the abolition of the State Rehabilitation Organization (SRO), the organization which hitherto had the task of restructuring State firms to enable them to keep going, often through merger with a more profitable unit. As a result, responsibility for some of the major enterprises being restructured and/or privatized by the SRO (such as the bus manufacturer Ikarus) now passes to the State Property Agency.

Strictly speaking, the above data are insufficient to indicate the expansion of the private sector. According to Statistical Office data for 1990, however, about 90% of the new organizations established up to September have no legal predecessor; most can be assumed to be private. From this, it can be estimated that about 40% of the total number of economic organizations were private by September 1990, and the private share was rising rapidly.[2] On the other hand, the private sector's weight in output and employment remains very small: in industry only 3 to 4%, and for the whole economy only 10 to 15%.

Aside from new domestic businesses, a second source of private activity in Hungary is joint ventures with foreign firms. By early 1990 there were over 1 600 joint ventures in operation. Their share in total production was estimated at about 5,5%, and their share of total investment at about 11%. This foreign capital investment, estimated at FT (forint) 30 to 50 billion (UKL 150 to 250 million) per year, can be regarded as the lower limit of the extent of private ownership. Thus with State property estimated at about FT 2 000 billion, this implies 1,5 to 2,5% privatized already. An upper limit is provided by the estimated FT 115 billion value of the companies already operating as joint-stock companies, limited liability companies or some other Western-type form of company.[3] This gives a figure of 6% for the extent of private ownership. This is certainly an overestimate, however, since the partnership form does not imply private ownership: most owners are still State-owned firms, financial institutions, and other State agencies.

2.2. Poland

As expected, the private sector in Poland adjusted much better to the new conditions created by the stabilization programme introduced at the beginning of 1990 (elimination of shortages, new structure of relative prices, increased competition resulting from trade liberalization) than the State sector. 'Creative destruction' worked relentlessly and a great number of private small-scale enterprises ended their activity, but many more were created. In 1990, the number of private firms increased two-and-a-half times, while the number of State enterprises grew only by 3%.

Most of the increase was due to the spectacular rise in the number of private shops and retail-trade enterprises, albeit from a very low base compared with Hungary: in 1990, more than 58% of the new private enterprises (i.e. about 300 000 out of 516 000) were trade enterprises. Their sales increased dramatically. Private sector sales rose 4,5 times, while total retail sales fell by 16% (see Table 4).

Industrial output of the private sector increased by about 8% in 1990, in contrast to a 23% fall in State-sector industrial output. As a result, its share in total industrial output is estimated to have been over 11% in 1990, as against only 4,8% in 1989. Employment in the private sector outside agriculture reached about 16% of total employment in 1990,

[2] Data from the Court of Registration of Capital offer more detailed information for a subset of new firms. Thus, of 2 198 limited companies (as of August 1990), 1 091 were exclusively owned by private individuals, 287 belonged to State-owned firms, and 820 were in mixed ownership. On this basis, it could be estimated that at least a third of economic organizations operate completely outside the public sector.

[3] In 1989 about 100 State-owned firms disintegrated into a mass of partnerships, and in 1990 about 70 more did so; most of the new firms created in this process do not, strictly speaking, belong to the private sector.

Table 4

Formation and closure of economic units in Hungary by employment category in the first three quarters of 1990

Employment category / Type of change	Number of employees 1-20	21-50	51-300	301 +	Unspecified	Total
Formations	8 709	1 724	948	461	19	11 862
Of which: with no predecessor	8 541	1 496	430	298	18	10 784
Closures	153	118	118	59	25	473
Total number of changes	8 862	1 842	1 066	520	44	12 335

Source: Statistical Office data (unpublished), Budapest, 1990.

Table 5

Percentage growth of total and private sector output, sales, investment and employment in Poland (Previous year = 100)

	1989	1990
Industrial output	99,9	77,0
private sector	122,0	108,0
Retail sales	97,3	84,0
private sector	161,8	450,0
Investment	97,6	92,0
private sector	102,6	97,0
Employment	99,0	97,0
private sector (excluding agriculture)	127,0	127,0

Source: *Informacja Statystyczna*, 8 January 1991.

as compared with 10% in 1989 (see Table 5). Also, credits extended to the private sector grew rapidly, from only 2% of the total in 1989 to 10% in 1990.

The number of joint ventures rose very rapidly during 1990. By the end of the year, 1 645 were registered in Poland, as against 436 at the end of 1989. A project for a new liberal law on joint ventures, allowing for full transfer of profits and dividends, was submitted to the parliament in February 1991.

2.3. Czechoslovakia

In Czechoslovakia, the private sector was the smallest of the three countries in this study, accounting for less than 0,5% of non-agricultural output in 1988. Within agriculture, private farmers (most of whom are collective farmworkers who also farm private plots) accounted for only about 4% of the sector's output. In trade and services, the situation was not greatly different, with about 65 000 private individuals in such activities at the start of 1990, as against close to half a million employees in State firms and cooperatives in the trade sector, and a further 1,5 million in the remainder of services. Thus at the start of Czechoslovakia's reforms, the private sector was scarcely noticeable.

Since May 1990, a new law on the creation of private firms has been in force in Czechoslovakia. The law allows new firms to be formed, with no restriction on the number of employees or the area of activity, the only requirement being registration in a special court. The government supports this development by allowing accelerated amortization, some deferment of taxes on wages, and incentives to reinvestment.

However, some barriers still remain. One is the remaining controls on exports and imports. Access to certain inputs, as well as credit, is also proving difficult. Credit is especially difficult, since the commercial banks remain State-owned and bureaucratic, and subject to a highly restrictive monetary policy. Moreover, they do not really compete and lack the financial and business skills needed to assess the profitability of projects. Hence they prefer to provide credit to State-owned firms because of established connections and guarantees. Most new private firms are in no position to offer suitable collateral for a loan. Thus by the third quarter of 1990, credit to private entrepreneurs was only CSK 1,5 billion, about 0,25% of the total for the economy.

To illustrate the growth of private entrepreneurship in Czechoslovakia, membership of the Association of Entrepreneurs can serve as an indicator (see Table 7).

Table 6

Poland: Employment and production in the private sector[1]

	1985	1986	1987	1988	1989	1990
% of total employment	5,3	5,6	6,2	7,0	10,1	16,0[2]
% of total industrial output	3,2	3,4	3,6	3,9	4,8	11,0[2]

1 The table refers to the private sector outside agriculture.
2 Estimated.
Sources: Rocznik Statystyczny, 1990, and data provided by the authorities.

The data should be treated with caution, but they do reveal the main trend. Note, however, that most people are private entrepreneurs only as a second job at present, and many of the registered businesses may not yet be active. Most of the private activity to date is in the trade and service sectors. This is as one would expect, since these branches have the lowest capital requirements and are therefore easiest to enter. Moreover, there is clearly a strong demand for additional provision in these branches.

3. Privatization of State-owned enterprises in Hungary[4]

3.1. Legal framework

Over several years, including the period before the election of a non-communist government in spring 1990, Hungary introduced measures to encourage private or quasi-private activity, and to limit the State's proprietary rights. Thus even in the early 1980s there was legislation to permit a wide range of small economic units, forms of small enterprise and association (see Hare, 1983), and their number increased rapidly for several years. As a result, by the late 1980s, many of Hungary's shops and small businesses had already been leased out to existing managers (or other potential future owners), so that in this respect Hungary was well ahead of the other two countries studied here.

Within the State sector itself the State's rights were restricted in 1985-86 by the introduction of enterprise councils in two-thirds of all enterprises (covering half the employees and capital stock). Under the conditions of the former system of economic management, this reform was seen as a way of granting greater independence to firms without threatening the overall system. The councils (or assemblies of workers' delegates) had the power to appoint the director, to determine the company structure, to decide about mergers and de-mergers, and to establish new economic organizations. The last included, after the 1988 enterprise law came into effect in January 1989, establishing partnerships which included some State property. This was the legal basis for the early, so-called 'wild' privatization.

The transformation law of July 1989 sought to regulate the conversion of State property into partnership form (commercialization) by recognizing the rights of the councils but putting some constraints on the process. These concerned the raising of capital, the entry of external owners, and the requirement that 80% of the shares and securities were due to the State Property Agency (SPA) as owner (or as representative, in law, of the State's ownership interest). Unfortunately, this law was easily evaded,[5] since it applied only to fully transforming companies, and most chose to retain a small State enterprise as a 'property administration centre', a unit which held nothing but shares in the newly created spin-off companies, and perhaps a small administrative staff.[6] Other shares would be held by other State firms (e.g. major customers or suppliers; and the banks, which often converted some of the firm's debt into equity).

The State Property Agency itself was established only in February 1990, under parliamentary supervision and with rather limited scope. Its formation under the former communist government of Hungary was a response to public concerns aroused by unfavourable reports about certain cases of spontaneous privatization.

4 Based on material collected and a report submitted by Eva Voszka, a researcher at Financial Research Ltd, a well-known Budapest-based research institute (it used to be located within the Ministry of Finance). In addition, Pál Valentiny of the Institute of Economics, Budapest, provided helpful comments on an early draft of this section, as did Marta Surányi at LSE.

5 By February 1990, the transformation law had been applied in full to only nine enterprises.

6 This issue of 'shell' companies has now attracted the attention of the authorities, who are seeking to identify and supervise them. Several were already under close supervision by summer 1990, and more were likely to be added to the initial list. For fuller discussion, see Juhasz (1990).

At the same time, an Act on the protection of State property entrusted to enterprises (the Protection Act) was approved. It governs transactions of at least FT 20 to 50 million (the precise lower limit depending on the form of the transaction) which involve the direct or indirect alienation of 'equity' interest in Hungarian business organizations, whether by sale of assets, stock or lease. The right to approve such transactions resides with the SPA.

After the elections, and the formation of a new government led by the MDF, it was clear that the State would reassert its proprietary rights and favour a more centralized approach to transformation and privatization issues. Accordingly, the SPA was placed under government control in July 1990, and in September its scope was greatly extended. Thus State enterprises could adopt a new company form (joint-stock company or whatever) only following preliminary examination and approval by the SPA. The resulting contract concerning the reorganization would also be signed by the SPA rather than by the company itself. At the same time, the law on foreign investments was modified. On the one hand, joint ventures no longer require a permit even when foreign majority ownership is involved, but on the other, the generous tax allowances and holidays have now been restricted to shorter time periods and fewer branches of the economy.

To sum up, market institutions, such as commercial banks, a bond market and now (since June 1990) a stock exchange, are already well established, while in November 1990 there was a new law on competition and prices. Enterprise law and laws applying to foreign investment are all quite satisfactory. However, this is not to say that all the new institutions and legal arrangements are yet working well. Particular doubts remain about the banks, since they still hold substantial amounts of debt in poorly performing enterprises. As a result, it is most likely that bank balance sheets will require major restructuring as part of a large-scale privatization programme.

Also, the legal regulation of the privatization process itself has been slow and uncertain, with legal provisions often correcting or changing processes that were already under way. Although this could be interpreted as a flexible approach, the frequent changes and delays have also created uncertainty for investors and other agents, and have facilitated the evasion of the law. The new government has been widely criticized for being slow to develop a clear programme to reduce the role of State ownership in the economy. On balance, however, we conclude that the combination of stated government policy goals along the lines indicated below, together with institutional developments such as the SPA, should allow Hungary's privatization to proceed satisfactorily even without a formal privatization law (subject to certain very important reservations discussed in the final section).

3.2. Privatization

Hungary's privatization programme for the coming three years was prepared in summer 1990, but few details were announced until the autumn, along with the rest of the government's programme. Over a three to five year period, Hungary expects to privatize about 50 to 60% of State-owned assets, including the bulk of those in the so-called productive sectors of the economy. Partly because of the size of the (internal) government debt and partly because of its concern to improve enterprise management by concentrating ownership, Hungary rejects the idea of issuing coupons to the population at large (although there will be a limited give-away of shares to local councils, insurance funds, etc.). However, about 10% of shares will be made available to workers in the relevant firms at reduced prices, and subsidized credit will be available to allow workers to buy more (provided that they put up at least 20% of the share price). Personal investments in shares and joint ventures will be offset against taxable income from 1 January 1991.

For the bulk of State enterprises the Hungarian programme recognizes three types of privatization: State-initiated, enterprise-initiated, and externally initiated. In the first category, about 500 to 600 firms should be privatized over the period 1991-93. Those expected to have a future will mainly be sold through the stock exchange, while the weakest firms will be reorganized or entirely liquidated. (The World Bank and the Ministry of Industry and Trade are already studying how to identify such firms.) A variety of methods of sale will be used, including open and closed auctions, share issues, and leasing of State assets.

In the second category, about 300 to 400 firms are expected to choose to be privatized in the next three years. The third category is expected to be especially important for small and medium-sized enterprises. It provides an opportunity for any potential buyer of a firm, domestic or foreign, to make a proposal to the SPA. In principle the SPA is required to give a response within 30 days. It is not yet clear how effective this provision in the law will be, especially as it is easily evaded by requests for additional information (which may give another 30 days) or by declarations that the firm concerned might take part in one or other of the SPA-initiated programmes. Nevertheless, in principle, the availability of these three approaches, which recognizes the need to decentralize at least part of the privatization process and also gives opportunities to outside investors to declare an interest in acquiring certain firms, is both liberal and flexible.

Only a few concrete measures to implement this ambitious programme have been announced so far. One important step was the privatization law (the so-called 'pre-privatization') covering retail trade, the catering industry and other small

scale service companies. In this sector, the existing State-owned companies' rights of disposal over individual business units have been suspended, but the SPA must organize their sale or disposal within two years. Although this has the advantage of accelerating the privatization of this sector (although still more slowly than expected in Czechoslovakia or Poland) within a clear legal framework, the drawback is that foreign capital will be excluded from this part of the privatization programme (politically, of course, the exclusion of foreign capital from this part of Hungary's privatization is quite understandable). Moreover, in many cases the privatization will be incomplete, since if the existing company was not the original owner of the business premises concerned (and this is widely so), then the new private entrepreneur can only lease the assets. Legislation to provide a general right to purchase may follow, but this is not yet clear. The rights of former owners, where they can be identified, also remain to be clarified.

Further details of this part of Hungary's privatization programme, along with the full list of businesses to be included in it, were still being discussed in spring 1991. Along with the SPA, the programme will be managed by the Ministry of Finance (which, since the appointment of a new Minister, seems likely to assume the leading role), the Ministry of the Interior (which supervises the local councils and hence controls the disposition of their assets), and the Ministry of Industry and Trade. A joint committee will be established to supervise the work of the team dealing with practical issues of administration, information, and so on. Where relevant, independent bodies will be called in to value the assets of the businesses being privatized.

In other spheres there is no general legislation to regulate the pace and direction of privatization, but the SPA has started to develop specific programmes, as well as continuing to deal with individual cases. On the latter, the SPA dealt with 42 cases in its first eight months (March-October), of which 6 were vetoed, 14 were approved and 22 were still in progress. In addition, the SPA dealt with 77 transactions covered by the protection law, and 13 of these were vetoed, mainly for the improper or incorrect valuation of assets (*Report of the SPA*, November 1990, Budapest).

The Agency now has to deal with more cases, however, since it must now approve every transformation, as indicated above. It has also taken several companies under its administrative control, such as Ganz-Danubius; this is probably to facilitate essential reorganization prior to privatization. The basic problem for the SPA is that it is currently very small but has enormously wide-ranging responsibilities to supervise all aspects of privatization in Hungary. It is questionable whether the agency has the capacity to do this. More exactly, if it takes its responsibilities too literally, and the small number of senior staff in the Agency insist on approving each application, then privatization is bound to be slow. The alternatives are to adopt 'bureaucratic' rules of thumb to speed up decisions, or to decentralize the management of the whole process. The Agency could also be greatly expanded, but this might be constrained by the lack of suitably qualified staff. In this connection, Tardos has criticized the present centralized approach and argued that the privatization process itself should largely be privatized (Tardos, 1990).

In September 1990, the first privatization programme was announced, involving the sale of 20 companies, mainly companies regarded as sound and with good development potential, including retail trade and catering industry businesses (see State Property Agency, 1990). Their total equity amounts to FT 33 billion (roughly USD 0,5 billion), while the total book value of their assets amounts to FT 73 billion. The SPA commissioned consulting firms and financial institutions to carry out this privatization. It did so by preparing prospectuses for the firms concerned, and inviting expressions of interest and tenders (from single firms or consortia). By December over 200 tenders had been submitted, and these were to be assessed by early 1991. The successful bidders would then have to carry out the actual privatization of the firms concerned (which may involve restructuring, reorganizing the balance sheet, and management changes), a process expected to take several months.

The basis for choosing the first 20 firms was not altogether clear (see Appendix for a full list), but the privatizations will be accomplished by a variety of methods, including public share offerings (with listing on the Budapest Stock Exchange, and possibly elsewhere), tenders (possibly with restrictions on who can bid), and some possibility of management buyouts and employee share ownership plans.

It was widely expected that this stage of privatization would be a success, but the situation may be different with subsequent batches of firms, likely to include some firms with very poor economic prospects and a history of loss-making. Groups of firms are expected to be brought forward for privatization every two or three months. Indeed, in early December 1990, a second privatization programme was announced. This focuses on so-called 'shell' companies where at least 50% of the assets have already been transferred to the forms of joint stock or public limited companies. Several other programmes are also under consideration, including the privatization of 'historic' vineyards, parts of the construction industry and some of the companies in monopoly positions.

It is clear that the Budapest Stock Exchange, formally reopened on 21 June 1990, is expected to be a significant player

in the privatization programme. Before its reopening it had already gained some experience with secondary trading in securities, and Hungary had had a bond market since 1982. However, although some FT 30 billion of debt had been issued through the bond market by 1988, the market then virtually collapsed as a result of higher inflation (bond issues had all been at fixed interest rates, and real returns turned sharply negative), the introduction of the income tax (which included a tax on interest income), and the termination of State guarantees for bonds issued by companies. In the new stock market, almost all the trading is in equity, with the bond market scarcely functioning. There are normally 8 to 12 actively traded shares, of which two are listed (as of December 1990), the rest unlisted; volume of business is at present very low, in the range FT 6 to 60 million daily. The stock exchange is largely self-regulating, but the Ministry of Finance has established a Securities Supervisory Board to provide for closer regulation as and when required.

Privatized companies are expected to provide the main business for the stock exchange soon, with plans for 30 to 40 listed firms by the end of 1991. This would represent rapid growth for the stock market, but seems to imply that the SPA may not be able to privatize as many firms as it should, according to the government programme.

The Small Venture Development Office and the Subsistence Fund (Egzisztencia Alap) have been formally established but are not yet functioning effectively. The latter was meant to provide domestic entrepreneurs with preferential access to credit to facilitate privatization. But the Fund still has very limited resources, although the Hungarian National Bank has allocated FT 4 billion of the Fund's initial capital of FT 8 billion, the remainder coming from a German credit to Hungary (see Fund, 1990). Also, the Fund's scope and criteria for providing credit remain undefined. This is likely to hinder certain privatizations desired by the SPA, and in general puts domestic private capital in a relatively disadvantageous position.

The scope of Hungary's privatization has come under discussion recently. Thus in some sectors, such as the banks and other financial institutions, there are severe doubts about the desirability of privatization at all (see Asztalos, 1990). Despite this, some of the commercial banks are apparently already preparing themselves for possible privatization. In the area of publicly provided services (e.g. health and education), too, privatization is unlikely to occur soon, although private provision will no longer be prohibited. Much of the capital required to provide such services is being transferred formally to the new local councils elected in late 1990. In the near future, housing will be the main local asset to be sold to the population, but the rate of sales is not yet clear.

Finally, especially in the countryside, the question of land sales or transfers is a controversial matter. It is partly connected with the Smallholders Party's policy of restitution to former owners, although on this the government is most likely to agree limited financial compensation in certain cases rather than the actual return of property. The real issue in the rural areas is what should happen to existing State farms and cooperatives. While individual State farms will probably be privatized *en bloc* just like State enterprises in other branches of the economy, the future of the cooperatives is less clear. In some parts of the country it seems that land is already being divided up into smaller plots for individual farms, despite the lack of legal sanction for such moves.

In the light of the above, the Hungarian privatization programme faces a number of problems. First, the extreme centralization of much of the process in a single small organization, the SPA, is likely to render the transformation bureaucratic and slow. Furthermore, the limited information available to the SPA may well, in practice, preserve the existing powers of managers and maintain the decisive role of bargains between firms and the government.

As far as drawing up privatization policy is concerned, this was initially neither the responsibility of the SPA nor of any individual minister. Instead it was a task for the Economic Policy Secretariat under the prime minister. Over the period June to November 1990, the views from this group changed substantially, from strongly favouring the centralized approach initially adopted in Hungary to proposals for company 'self-privatization', which would essentially continue early trends towards spontaneous privatization. In practice, if the overall goals for privatization are to have any realistic chance of being achieved, Hungary's approach may well have to move strongly in this direction, perhaps even with a requirement that firms prepare privatization plans for themselves within a specified, and preferably quite short, period (as seems to be envisaged in Czechoslovakia, see below). Many firms appear to be doing this already.

In any event, new guidelines for privatization (to guide the activity of the SPA) will be debated in parliament in early 1991. Also, as noted above, the new Finance Minister and the Ministry of Finance have taken the major responsibility for determining policy on privatization.

Views about the new owners are also very diverse, with all sorts of ownership now under consideration, both foreign and domestic, and including employee shares, too. Such an eclectic approach has the merit of flexibility and adaptability, but it also means that State priorities remain unclear and may be influenced by bargaining. But in practice, it may be extremely hard to settle priorities in advance, and there may be no choice but to try a variety of approaches in several different sectors, and gradually learn what is most effective.

Finally, given that half the economy will still be in State hands by the end of 1993, it is obviously important to find ways of managing public-sector firms more effectively. They cannot just be placed in a queue awaiting privatization, with no action being taken in the mean time. According to the director of the SPA, current plans are not well developed, but the intention is to change management of the most unprofitable firms, restructure some of them to protect viable parts of the various businesses, and force those which are unable to improve into liquidation. One helpful step was the elections for enterprise councils in autumn 1990. All managers in the enterprises concerned had to submit themselves to re-election. Some simply chose to resign, others were not confirmed in their positions. Although most were re-elected, this exercise should have allowed some of the least effective and most politically 'tainted' managers to be removed.

Kornai (1989) has argued for a fairly centralized management of the public sector, but given the established strength and relative autonomy of existing enterprise managers this is probably unrealistic both economically and politically. But whatever is done by the government must convince managers that their survival now depends on successful adaptation, restructuring and profitability. Pressures on the budget will be helpful in this connection, since managers can see that their usual source of subsidies is drying up; and banks, too, are likely to become less supportive as they become increasingly concerned about the profitability of their loan portfolios. But on the other side are the government's continuing fears about large-scale unemployment (unemployment was only just over 1% of the labour force at the end of 1990), and their associated reluctance to allow many large bankruptcies. At present it is hard to judge where the balance between these pressures will be struck.

What sort of private sector can one envisage in Hungary, in the light of these trends? Strictly speaking, it is really too soon to say, but the most important tendencies in practice have so far been the rapid extension of the private sector through its own efforts, unconnected with privatization, and the transformation of State-owned companies into partnership form (mainly joint-stock companies), with ownership dispersed among a number of State organizations. Both of these tendencies result from managerial initiative and in themselves provide no means for bringing about a fundamental restructuring of the economy, entering new markets, and modernizing the firms concerned. Thus the economy could develop into a dual structure with a small-scale, competitive private sector constructed *ab initio* alongside a transformed State sector (increasingly commercialized), which continues to be well connected with State structures and is gradually being privatized. This could form the basis for a corporatist form of economic structure.

4. Privatization of State-owned enterprises in Poland

4.1. Public opinion on privatization

It is difficult, and may even be misleading, to make any strong statements about the public's attitudes towards privatization because in Poland it does not yet represent a concrete experience. The general acceptance of the idea of privatization (according to public opinion polls taken in September 1990, 74,1% of people considered privatization as necessary, and 18,1% as unnecessary or harmful) is accompanied by a great deal of scepticism about its likely effects. Almost 70% think that in the foreseeable future (say, within five years), privatization will not yield any positive results. Also, it is expected to have more positive effects on the Polish economy in general than on people's individual situations. This expectation of positive effects on the economy as a whole was more widely held among those with higher levels of education or greater wealth, and among younger people. Almost a quarter of the sample expressed a willingness to buy shares in enterprises being privatized.

On the question of the basic principles of privatization, about 30% stressed economic efficiency, while about two-thirds emphasized some principles of social justice (e.g. not harming anyone, avoiding the creation of new privileged groups). Aside from the general acceptance of privatization as an idea, other concrete questions all elicited contradictory answers, with the interesting exception of employee ownership, which was widely supported. Moreover, those favouring economic efficiency goals were more inclined to support employee ownership than those emphasizing various notions of justice.[7]

4.2. The Act on Privatization

Originally, the mainstream approach to privatization in Poland was close to the British approach, with careful valuations of assets, and their sale to individuals, Polish private firms and foreign investors through public offerings or negotiated sales. The first version of the Polish privatization law presented in autumn 1989 envisaged the transformation of all State-owned enterprises into joint-stock companies with all shares owned first by the Treasury and next the public

7 See Centrum Bandania Opinii Publicznej, 'Poglady na temat prywatyzacji', *Kommunikat z badan*, Warszawa, pazdziernik 1990; and CBOS, 'Prwyatyzacja w opinii spolecznej', *Kummunikat z badan*, Warszawa, listopad 1990.

sale of shares, with a certain number of them being reserved for the workers.

In subsequent versions of the programme, the government, sensitive to political pressures and increasingly aware that the orthodox approach to privatization comes up against some insuperable constraints (mainly the lack of domestic capital, and valuation problems), has been softening its position and significantly diversifying the methods of privatization envisaged. The Act on Privatization which was finally accepted by the Polish Parliament in July 1990 is the result of a compromise. It provides a general and very flexible framework for the privatization process, allowing for different methods of privatization and different forms of ownership: free distribution through vouchers, the sale of shares, individual and communal property, and employee ownership.[8]

According to the law, State-owned enterprises can be privatized at the initiative of their own management and workers' council (in some cases the Minister for Ownership Transformation can also order the transformation of an enterprise). Two privatization tracks are available: the transformation of a State-owned enterprise into a Treasury-owned joint-stock company (with the agreement of the Anti-Monopoly Agency) whose shares should be disposed of within two years, or the liquidation of an enterprise in order to sell its assets, use them as a contribution to a new company, or lease them for a fixed period.

During the vigorous, six-month debate preceding the law's passage, the advocates of employee ownership confronted those supporting 'citizen ownership' (as its proponents called it). In the event, the self-management lobby lost the day, but workers in privatizing companies were granted the right to buy up to 20% of the shares at half price. The upper limit of the discount was to be determined by the product of one year's average pay in the given enterprise and the number of employees purchasing shares. Provided that over half the shares remained with the Treasury, a third of the members of the Board of Directors would be elected by the employees. The Act also provides that privatization coupons (or vouchers) might be distributed freely to all citizens, allowing them to acquire shares of privatized enterprises, title to participation in financial institutions, or a share of the assets of wound-up firms.

According to the law, foreign investors can buy up to 10% of any privatizing enterprise. Beyond that limit, they need the approval of the President of the Foreign Investment Agency. This provision, clearly a concession to the political pressures in Poland, provoked a very negative reaction in the West. Different representatives of the Polish Government are doing their best to limit the damage and assure potential investors that approval would be readily forthcoming; but unfortunately, the negative message was sent.

The passage of the law formally opened the way to the process of privatization of State-owned enterprises. But with such an eclectic law it was clear that the final decisions about the actual privatization strategy had only been postponed. The newly established office of the Minister for Ownership Transformation (who was only appointed two months later) was made responsible for the preparation of guidelines for privatization, and for the implementation of government policy on ownership changes. It took the next four months to prepare a privatization programme, but the preparatory work for the privatization of the first batch of enterprises started immediately.

4.3. Actual developments

In 1990 only a small fraction of the Polish economy was actually privatized. It took some time for the Ministry of Ownership Transformation (MOT) to organize itself, and for State enterprises to take decisions about entering a particular privatization track (the procedure was based, so far, on voluntary applications). But by the end of 1990, the process began to get moving: the legal and institutional framework for privatization was worked out and the first decisions were taken on developing the financial infrastructure. A securities commission and security law are being prepared (the US Securities and Exchange Commission will provide technical assistance to train staff), and the stock exchange is in the process of being established with help from the French Stock Exchange Association (the Lyons stock exchange has been chosen as a model for Warsaw).

So far, the actual process can be presented under three headings: the so-called 'small' privatization which relates to the communal property (that is, property controlled by local governments); privatization through the transformation of the State-owned enterprises into joint-stock companies and the sale of shares; and finally, privatization through liquidation and the sale of assets. We shall present an outline of each category of ownership transformation, without pretending to give a full overview of the process, which is sometimes chaotic and difficult to grasp.

4.4.1. 'Small' privatization

According to the law, from May 1990 the ownership of or part of State assets (land, building lots, shops, restaurant

8 Three other fundamental laws, currently in preparation, will complete the regulatory framework for privatization: the Treasury Act, the Polish [illegible] Act, and the Act on Reprivatization.

rtments) was effectively transferred to the local authori- (municipalities or communes), which therefore became onsible for their privatization. The transfer of property ts to private hands was rapidly initiated, often producing ain tensions but also sometimes yielding remarkable re- s.

latter are particularly noticeable in the case of privatized ps, which quickly change the appearance of towns and quality of everyday life.[9] Although on 1 October 1990 civil code was changed to allow for the sale of different mises, shops are mainly rented or leased. Each commune y decide whether the employees should be given prefer- e in renting shops, in which case a fixed rent is charged.[10] ere auctions are the chosen method of privatization, en outrageous prices provoke strikes by the employees result in the disappearance of traditional services: thus oblers or laundry services are replaced by luxury bou- ues. Sometimes, in order to protect the interests of con- ners, local authorities compel the new owners to guaran- that they will provide the same kind of services that isted before privatization (similar restrictions are also ing proposed in Czechoslovakia). Nevertheless, consumers ten complain that even if, for instance, food products are ll sold in a privatized store, basic goods such as bread, tter, milk or potatoes are replaced by luxury imported ods. The problems should disappear with the gradual abilization of relative prices.

ensions associated with the 'small' privatization are basi- lly due to the fact that the legal and regulatory framework lagging behind the actual process. Unresolved issues clude re-privatization (i.e. the restitution of State property former owners or their legal successors), the absence of lear, unified methods of valuation, and of clear preferences owards the existing employees. These generate conflicts which, to a certain extent, may be unavoidable, but they onfirm once again the importance of trying to get the equencing right. However, some obvious transgressions of he established rules have also been noted (sales of assets far elow their estimated value, no public information about he sale, and so on).[11]

The process of privatization of State trade accelerated in the closing months of 1990. It has been estimated that 40 to 50% of the total number of shops were transferred to private hands in 1990.

In Warsaw, for instance, the employees of privatized shops were treated differently in different districts. In Mokotow district, where the process went smoothly, 80% of shops were taken over by the employees, and about 20% were auctioned (*Rzeczpospolita*, 29 October 1990).

For instance, the privatization of pharmacies, supervised by the Ministry of Health as the relevant founding organ, proved to be a notoriously irregular process. The Supreme Chamber of Control (NIK), responding to a motion from a group of deputies, decided to look at it carefully.

4.4.2. Privatization through 'liquidation'

The Act on Privatization describes in detail the privatization of State-owned enterprises through their transformation into joint-stock companies and the sale of shares. The second privatization track, winding up an enterprise in order to dispose of its assets by selling them, contributing to a new company or leasing them (with or without the right of acquisition) to a corporation with worker participation, was somehow neglected by the legislators. It was probably considered of secondary importance. The liquidation procedure was not clearly described: it was implicitly assumed that it would conform to the rules determined by the Act on State-Owned Enterprises. However, the latter only allows for the liquidation of unviable enterprises, while privatization through liquidation under the Act on Privatization of State Enterprises also applies to enterprises in a viable financial condition. Moreover, unlike the former Act, it also allows for leasing assets.

Once again, the regulatory framework seems to be lagging behind the actual process. Unexpectedly, applications by State enterprises for privatization through liquidation are increasing rapidly: it is by far the most popular means of ownership transformation. In some cases, it seems to be used as a subterfuge, opening up the otherwise closed door to employee ownership.[12]

Up to the end of January 1991, the Ministry of Ownership Transformation had received 139 applications for liquidation.[13] Of these, 88 have already entered the liquidation track. 31 enterprises in poor financial condition have been accepted for liquidation under the Act on State-Owned Enterprises, and their assets will be sold at auction. 57 enterprises will be wound up in accordance with the Act on Privatization, and their assets will generally be rented out/leased to companies set up by the employees of the previously State-owned firms. The remaining candidates for liquidation are awaiting a decision by the Ministry.

Such a centralized approach to privatization poses the problem of the processing capacities of the Ministry, which is unable to deal effectively with the growing number of applications. Aware of this constraint, the Ministry intends to alleviate the burden by working out simplified privatization procedures, and by delegating part of the responsibility to regional privatization agencies. This in turn might encounter

12 See a case study described by Zbigniew Grzegorzewski, 'Wlascicicle jednej cegly', *Zycie Gospodarcze*, 27.1.1991.

13 The number of applications sharply increased in the last few days of 1990. The reason for this was the expected reassessment (revaluation) of enterprises' assets (by almost three times), which would increase the costs of acquisition or leasing of assets by worker-owned companies.

difficulties due to the lack of experienced people with the right skills to staff such agencies effectively.

4.4.3. 'Pilot' privatization: transformation into joint-stock companies and the sale of shares

Seven companies were originally selected for the first wave of privatization through an initial public offering of shares. Starting in August 1990, they went through a complex process of auditing and valuation with the help of foreign consulting firms, partly financed by the British Government's Know-How Fund. In one firm (the rolling mill Norblin), problems of valuation proved to be insuperable and it was removed from the first batch.[14] Another (the meat processor Innowroclaw) was transformed into a limited liability company and then sold to 320 (of the total 350) employees through a leveraged buyout.[15]

The shares of the remaining five firms were publicly offered for sale on 30 November 1990. Subscriptions, accompanied by an aggressive and controversial campaign (prepared by a French advertising agency for over a million dollars), were originally scheduled to last for three weeks. But only one company was sold on time, and subscriptions went on for another three weeks. Finally, for the 4 330 000 shares offered for 300 billion zlotys (ZL) there was an over-subscription of about 7% (over 130 000 buyers applied for a total value of ZL 320 billion).

This was presented as a success story, and as far as the demand for shares is concerned it may be interpreted as such; Table 8 shows the ownership structure of the new firms. The difficulties were rather due to tactical mistakes and organizational weaknesses in the process. Declarations by Ministry officials that priority would be given to small shareholders were misleading and discouraged larger, strategic investors; they were only explicitly invited to come in at the very end.[16] Organizational and marketing problems proved to be overwhelming: the banking system clearly failed to manage an additional volume of transactions. A poor organization of the subscriptions delayed the process, with long queues,[17] insufficient prospectuses and a lack of informed advice.

Table 7

Membership of Czechoslovak Association of Entrepreneurs

In Czechoslovak Federation:	
31.12.1987	38 200
31.12.1988	51 200
31.12.1989	86 900
31.1.1990	148 500
30.6.1990	224 100
In Czech Republic:	
1.12.1989	65 202
31.3.1990	109 970
30.6.1990	163 952
30.9.1990	255 851

Table 8

Poland: Ownership structure of the first 'Five'

Company	Public	Employees	Invitation to negotiate
Exbud	45	20	35[1]
Kable	83	17	
Prochnik	80	20	
Krosno	50	20	30
Tonsil	50	20	30

[1] Of which 17,5% for managers, 17,5% for a core investor.

Source: Ministry of Ownership Transformation, Warsaw.

The next challenging task is how to organize the secondary market for operations later in 1991, but in order to ensure the credibility of the privatization process, shares in these newly privatized firms must be tradable sooner than that. This presents the banks with an immense and difficult task

[14] First, a Polish consulting firm, Procsim, prepared a preliminary report based on performance over the previous three years, and concluded that Norblin qualified for privatization. In 1990, however, the financial situation of the firm deteriorated, and four British consulting firms (Coopers and Lybrand Deloitte, Barclays de Zoete Wedd, Baker McKenzie, and Central European Trust), preparing the company for privatization, suggested methods of privatization other than a public offering.

[15] The value of the enterprise was estimated at ZL 30 billion, with a book value of ZL 5 billion. The employees paid 20% in cash, and obtained a five-year credit, at a subsidized interest rate, to support their purchase.

[16] One of the largest investors, the insurance company Westa, bought 20% of the shares in the clothing firm Prochnik. See *Rzeczpospolita*, 17 January 1991.

[17] The queues were intensified by the provision that everyone using Treasury bonds to pay for shares would get a 20% premium. The bonds originally issued in December 1989 (see Grosfeld, 1990), were still available at the time of these share subscriptions. Naturally, people queued first to buy bonds, then to exchange them for shares.

4.5. The privatization programme

The privatization programme for 1991 prepared in the MOT was accepted by the Council of Ministers and submitted to the Parliament in December 1990. In January 1991, after discussions with the Parliamentary Commission on Ownership Transformation, the new government resubmitted a revised version which, according to the law, will be voted on together with the annual budget (probably in February 1991).

The elaboration of the programme was influenced both by the actual development of the privatization process and by the accompanying debate. The valuation of the first 'pilot' privatizations, not unexpectedly, turned out to be difficult, time-consuming and expensive,[18] reinforcing the position of those who were advocating faster privatization. The need to accelerate the process was used as an argument in the presidential campaign, which created high expectations as to the possible pace of privatization: the latter is now largely perceived as the key element of an anti-recession strategy. The urgency of transforming enterprise ownership and clarifying its legal status was advocated as a means of eliminating dual power in the State-owned enterprises (which formally belong to the State, while the right to dispose of their assets is to a large extent exercised by the workers' councils).

Considerations of macroeconomic stabilization (a fear that the government might not be able to resist the strong pressure in favour of wage liberalization) also played a role in the debate on privatization strategy. Ownership transformation and the subsequent elimination of the excess wage tax were seen as a safety valve for the tightly controlled sector of State-owned enterprises. Starting from 1 January 1991, the excess wage tax does not apply to private and privatized enterprises and it is alleviated in the case of commercialized enterprises.[19] It appears, however, that there was some overshooting: getting rid of the excess wage tax has proved to be such a powerful incentive that a lot of enterprises apply for privatization even when there is no real prospect of finding a buyer; eventually, the only remaining option would be a leveraged buyout by the employees.

In order to realize the overall goal, which is to privatize over half the State assets within three years (essentially the same as the Hungarian objective), the Polish privatization programme combines the standard methods and an unorthodox approach based on free distribution.[20] The latter will apply to most of the largest manufacturing enterprises (the first 500, according to their gross sales, which amounts to 65,9% of sales, 73% of gross profits and 49% of employment of all Polish manufacturing enterprises). Selected large firms will be privatized in the classical way through public offering or outright sale to private investors. Small and medium-sized enterprises (over 2 500 industrial enterprises and 3 000 others) will be privatized through buyouts, sales or dissolution (liquidation).

Large firms requiring a diversified ownership structure will first be transformed into joint-stock companies and then about 70% of their shares will be distributed freely among citizens, workers (up to the limit specified in the law),[21] the Social Security Fund, and other financial intermediaries (in a previous version of the programme, commercial banks were envisaged as potential trustees of shares, but in the latest version, this idea seems to have been rejected). The State will normally retain a minority stake to be sold off at a later date.

About 30% of shares will be given to all citizens in the form of vouchers. In order to avoid negative consequences of such a dispersed ownership, create an effective corporate governance for privatized companies and provide some pooling of an unusually high risk for the citizens (because of the lack of any reliable information about the market value of the shares in privatized enterprises, and lack of understanding of the workings of capital markets), the vouchers would be exchanged for shares or units in several privately managed privatization funds. These funds would initially be owned and operated by experienced foreign firms with considerable investment expertise.

Although the exact design and constitution of the privatization funds are still under consideration, their role, and the mechanics of the process, are expected to be as follows. The funds would use the vouchers to bid for shares in privatizing

[18] Privatization of the first five enterprises cost USD 5,7 million, i.e. about 17% of their estimated value. See *Gazeta Wyborcza*, 23 January 1991.

[19] Namely those which have a corporate structure and a board of directors. Commercialization of State-owned enterprises became a controversial issue in Poland. Creation of a corporate structure is sometimes seen as a necessary step ensuring (political) irreversibility of the process. A strong resistance to commercialization comes from two sides: from those whose vested interests are taken away, i.e. workers' councils; and from those who consider it to be just a paper change, without substance.

[20] The case for free distribution was worked out in an important debate initiated by Lewandowski and Szomburg (1989); two recent, important contributions which heavily influenced the final shape of the programme were Frydman and Rapaczynski (1990), and Lipton and Sachs (1990a).

[21] It was suggested that employees should get 10% of shares free. However, it is not yet clear whether such a reinterpretation of the Act on Privatization would be accepted by the parliament, or by the courts. It may be argued that 10% free is equivalent to 20% at half price, but according to the law the discount should be determined by the price offered on the first day of sale. But in the case of free distribution the valuation would be postponed and book value is an extremely poor 'proxy'. Still, some method of giving away shares to employees must be found; otherwise they are not likely to accept a procedure which would delay significantly their access to ownership.

companies. How the auctions will be organized has not yet been settled. The original idea was to have a competitive bidding process which would ensure that the intermediaries would examine companies carefully as soon as possible, and that the allocation of shares in privatizing companies would reflect the relative valuations assigned to them by the privatization funds (see Frydman and Rapaczynski, 1990). However, the organization of an auction ensuring that the markets are cleared with each company having at least one large shareholder may prove to be cumbersome, and its transaction costs prohibitive. An alternative would be a simple allocation system, which is also contemplated in the Ministry of Ownership Transformation. A final decision will be taken after the feasibility studies for the voucher scheme and the privatization funds have been completed.

The incentive structure for the fund managers should induce them to manage the assets of the fund in the interests of the unit-holders, and to assume an active role in overseeing, restructuring and other activities tending to maximize the value of companies in the fund portfolio. The shares of these companies will be tradable. The fund will also manage the shares of the Treasury (30%) until the restructuring process is well under way and the shares can be sold (preferably to a core investor); the Treasury would appoint one member to the board of directors of each fund and would also have a golden share for approval of the sale of its stake. Initially, the funds will be organized as close-end funds. Once the shares of the underlying companies are listed on the stock exchange and the funds become more liquid, units in the funds will become redeemable. From the unit holders' perspective, the funds will be structured as mutual funds, making it possible to diversify risks and maximize the long-term returns to shareholders. From the companies' perspective, the funds should behave as venture capital funds.

This is the architecture of the programme. It poses a great number of policy issues and requires an exceptional organizational and logistic effort. Privatization funds, the key element in the programme, do not yet exist in Poland (and even in Western countries, such an intermediary institution combining the skills of a merchant bank, an investment bank, a venture capital manager, and an auditing and consulting company, is hard to find). The Ministry of Ownership Transformation intends to invite foreign financial intermediaries, possibly in cooperation with Polish counterparts, to establish such funds in Poland. The 'constitution' of the intermediaries should be carefully designed to ensure, on the one hand, that they have sufficiently strong incentives to come in and, on the other, that their strategy is compatible with the interests of the Polish economy.[22]

[22] For some discussion of possible forms of undesirable behaviour by these intermediaries, see Aghion and Grosfeld (1990).

Further policy questions include: how much choice should voucher holders have in disposing of vouchers and selecting funds? How should shares be allocated to intermediaries? Will funds be obliged to divest, and if so, how? Should vouchers be distributed in a physical form or as a book entry? Should they entitle people to shares in one intermediary or many? Should they be transferable and when would they expire? Should people have to pay for their vouchers (see section on Czechoslovakia)? What upper and lower limits should be established on fund shareholdings? Will there be any initial restrictions on trading in the funds' shares? How will the funds' managers be remunerated?

All these questions indicate a clear trade-off between the potential political impact of free distribution (dependent on the speed of the process and the degree of choice left to the public) and its operational and administrative burden. More generally, the whole privatization process seems to be constrained more and more by the administrative and organizational potential.

Finally, whatever the speed of privatization, a significant number of enterprises will remain for some years in the State sector. The government thinking about this problem includes the creation of holding companies in which private equity participation would initially be at least 10%, and which would be managed by foreign investment banks or other private partners. These holding companies would actively manage a portfolio of Treasury-owned companies until these are sold to the public.

5. Privatization of State-owned enterprises in Czechoslovakia[23]

5.1. Background

Unlike some of the other East European countries, including Hungary and Poland, Czechoslovakia begins its transformation from a more balanced initial macroeconomic position, although with far less experience of private-sector activity in recent years. Thus at the end of 1989 its external debt was about USD 8,7 billion, of which USD 7,9 billion was in convertible currencies; and the debt service ratio was about 20%. Also, the monetary overhang (i.e. the stock of forced savings held by the population) seems to be small, and the government has traditionally employed a very cautious fiscal and monetary policy. Finally, explicit budgetary subsidies

[23] Based on material collected by J-F. Nivet, Delta, Paris, during a visit to Czechoslovakia in November 1990, which enabled him to write a report for this project.

to industry are smaller than elsewhere. These should be further reduced from the start of 1991, in tandem with the introduction of price liberalization in Czechoslovakia.

On the other hand, the country's high dependence on Soviet oil and gas in recent decades, and its high exports to the Soviet Union, present serious adjustment problems in 1991, with substantial terms-of-trade losses. There will also be significant social resistance to the removal of consumption subsidies, and increasing difficulties in maintaining living standards, not least because improvements in living standards in the last few years have largely been at the expense of investment, and this can hardly continue.

Privatization itself is complicated, as in the other two countries, by the extreme concentration of production,[24] by the outdated capital and product mix, by serious valuation problems, and by the lack of savings. Accumulated savings are estimated at about CSK 330 billion, which represents only about 10% of the book value of State assets. As in most countries, the distribution of these savings is highly unequal, and there is widespread concern that a significant fraction of them may be held by members of the previous establishment and participants in informal or illegal markets.[25] Politically, it is considered impossible for the government to privatize in a way that would merely return economic control to such groups. In any case, privatization itself is not needed to deal with the monetary overhang since, as in Poland in 1990 (and in 1991 in Hungary, less dramatically), any problem of this sort will be dealt with through price liberalization and the creation of limited internal convertibility. Hence the existing proposals to make use of a voucher scheme (see Charap and Nivet, 1990).

5.2. Legal provisions

Although it has reformed the commercial code to permit private firms (see Section 2), Czechoslovakia has not yet introduced a law on bankruptcy (unlike Hungary). However, in late 1989 it improved the existing law on joint ventures to encourage more of them, recognizing that injections of foreign capital and expertise would make an important contribution to the country's transformation.

There is now no restriction on the share of capital that can be owned by the foreign partner, who can provide 100% of the capital. Favourable fiscal conditions are also offered: a profit tax rate of only 40% compared with 55% for a normal firm, with tax exemptions in the early years. Joint ventures were required to hand over 30% of their convertible currency profits to the central bank, but since the introduction of internal convertibility from early 1991 all foreign currency proceeds must be handed over, while foreign currencies may be freely purchased at the official rate.

The new law resulted in a rapid increase in joint venture activity in 1990. From only 20 at the beginning of the year, the total rose to about 600 by November, mostly in the service sector (tourism, consulting, etc.). Germany and Austria are at present the leading investors, although amounts of capital are generally small. Some of these ventures provided convenient vehicles for so-called 'wild' privatization, as in Hungary and Poland; however, the extent of such activity seems to have been rather less than in those countries.

An unusual feature of the Czechoslovak privatization process is the Law on Restitution, which came into effect in November 1990. The law deals with the nationalizations that took place after 1955, mainly of small businesses.[26] The goal of the law is to clarify the rights of dispossessed owners and hence remove a possible ambiguity from the definition of property rights. Former owners have six months to notify a claim and, once approved, compensation takes the form of physical restitution of the asset concerned. Of course, in some cases, this will not be possible because the original assets no longer exist or have been completely renewed or transformed; in such cases suitable financial compensation will have to be agreed. One can expect that the associated procedures will take some time, because of problems of information and the identification and verification of former owners. This could delay parts of the privatization process. This possibility is strengthened by a decision of the Czechoslovak parliament in late February 1991 to extend the law on restitution to cover nationalizations that took place between 1948 and 1955, a period that includes the nationalization of some of the largest firms:

A more serious issue is the nationalizations that occurred before 1955, mainly in 1948-50. They concerned the larger businesses in manufacturing industry, construction, commerce, etc. There is now some discussion about a possible

[24] Thus in the whole of industry, which produced 59,6% of NMP in 1988, there were only 813 enterprises in 1988. By early 1990, however, this had already risen to 1 133 as a result of 'spontaneous' deconcentration and a limited amount of 'wild' privatization.

[25] Precise figures on the distribution of savings across the population are not readily available for Czechoslovakia. However, a study of income distribution in Hungary and Poland (Flakierski, 1986), showed that the richest 10% of households in each country received about 20% of total household income. Since the institutional and policy environment was substantially the same in Czechoslovakia, the situation was almost certainly the same there. And as savings are generally far more unequally distributed than income, the statement in the text is probably a good approximation.

[26] But note that in mid-February 1991 the law was extended to cover nationalizations since 1948. Detailed arrangements for administering this part of the law had not been determined at the time of writing.

restitution law to cover this period, although finding the former owners would be far harder, and only financial compensation is envisaged. So far, Czechoslovakia is the only country which has passed any legislation of this kind, though the Smallholders Party in Hungary (part of the governing coalition) continues to demand something similar with regard to land in Hungary. Such proposals are likely to be resisted, however, except for some modest provisions for some financial compensation to former owners (see Section 3).

5.3. The privatization programme

The privatization process in Czechoslovakia falls into two parts: the small-scale programme involving sales of businesses for cash; and the large-scale programme based on the distribution of vouchers to the population. Both parts of the programme will make use of auctions.

5.3.1. The 'small-scale' programme

This will be run by local committees set up explicitly for the purpose. The committees are supposed to work independently, with the Ministry for National Property Administration and its Privatization (MNPAP) acting primarily as adviser, but also in a powerful supervisory capacity. Local committees will be required to prepare enterprises for privatization after a potential purchaser expresses interest. These arrangements impose no upper limit on the size of firm to be privatized in the 'small' privatization, provided that there is an interested buyer. Thus the 'small' privatization in Czechoslovakia is not the same as in the other two countries, since it is not confined to small shops, service establishments and factories (typically those formerly supervised by local councils).

The transfer procedure will normally take the form of auctions. Participants will be required to pay CSK 1 000 (for comparison, the average monthly salary is CSK 3 200) for each auction and to deposit 10% of the auction 'starting price'. The starting price will be determined by independent appraisals: it will comprise the estimated value of the land, building, equipment and machinery. Inventories are to be paid for separately. If there are no buyers at the predetermined starting price, current legislation allows the sale price to be gradually lowered to a minimum of 50% of the original price, provided that there are then five auction participants. It is not yet clear how this arrangement will work in practice.

In the first round of these auctions, only Czechoslovak citizens will be allowed to participate. But if the first round fails, a second auction can be held several months later in which foreign participation will be allowed. The proceeds of these sales go to the republic level of the State Funds of National Property, but they are frozen for two years except to finance the organization of further auctions.

The 'small' privatization was under way at the end of 1990 and continues during 1991. The first auctions obviously involve those businesses whose former owners are known or easily identified. At present it is not easy to judge how successful this form of privatization will be, although part of the population does appear to be willing to invest in shops, restaurants and other parts of the service sector.[27] But some problems remain. First, the high entry fee to the auctions (CSK 1 000) will deter many potential buyers, so this barrier should be removed except for foreign investors. Second, there is the issue of access to credit referred to above, and the population's inexperience with mortgage-type loans (as well as the inexperience of the financial institutions). The behaviour of the local committees, and of the local authorities which currently control the bulk of the businesses being privatized in this programme, will also be critical for success. Given the decentralized implementation of the programme, it will probably prove useful for the MNPAP to act as a clearing house/information centre on best practice as it monitors progress in different districts.

5.3.2. The 'large' privatizations

These concern larger firms which could not be bought by a single investor. While the general conception of the programme has been approved by parliament, including the principle of the voucher system, many details are still under discussion and final decisions are only expected in early 1991.

The main idea seems to be that each enterprise should be required to prepare its own privatization plan within two months. These proposals will then be submitted to the MNPAP in the Czech and Slovak republics for compilation into lists which will, in turn, be submitted to the republic parliaments for approval. After parliamentary approval, property would be auctioned for vouchers to the public. One exception to the voucher method in the large-scale privatization is the case of enterprises, such as joint ventures, with foreign capital participation. Shares in these firms will

[27] At the beginning of February 1991, the first auctions of businesses in the 'small' privatization programme were held in Prague. Bidding was lively, with some prices offered being far higher than expected, possibly unrealistically so. Businesses were not being sold outright, but leased for two years; thus extensions to leases will have to be renegotiated with the new owners of the various properties in two years' time.

only be available for cash sales, not vouchers; this could prove to be a significant limitation on the scope of the proposed voucher scheme.

Three categories of State-owned enterprises are distinguished. The first includes public utilities and other regulated State-owned enterprises in defence, telecommunications, etc. They represent about 30% of the State-owned enterprises and will remain in State hands. The second category includes the State-owned 'heavy industries', such as mining, metallurgy, engineering, etc. These will not be privatized in the early stages of the process, probably because many of these firms are loss-makers and require substantial reorganization and restructuring before they can be privatized. Also, Czechoslovakia may not yet be prepared to contemplate the large job losses that would necessarily accompany this process. The third category includes the State-owned 'light industry' enterprises, and this is where the first stage of the 'large' privatization will focus.

Between 500 and 2 000 enterprises will be proposed for privatization in the first round of the 'large' privatization, the exact number partly depending on the extent of demonopolization that is carried out before the process begins. Breaking up large firms is a difficult and controversial matter in all the countries under study here, and could be used as a pretext for delaying privatization. Probably Lipton and Sachs (1990a) are correct in arguing that external competition resulting from trade liberalization and internal convertibility will limit the exploitation of monopoly power, and that competitive forces will stimulate much of the required reorganization of industry over the next few years. Hence there is no compelling reason to hold up privatization.

Before privatization, enterprises will be commercialized, that is, transformed into joint-stock companies with a board of directors appointed by the government. This commercialization does not face the same problems as in Poland, for instance. For in Czechoslovakia the powers of workers' councils were never as great as in Poland (or Hungary, for that matter), and in April 1990 the so-called 're-nationalization' took place, dissolving the councils. In that respect, the legal framework and the definition of property rights are clearer than in other countries. At the same time, though, it is still not certain how enterprise capital structures will be treated at the commercialization stage: in particular, how will outstanding debt be treated, and how much of the book value of capital will just be written off or written down in preparation for privatization? (In the case of writing off loans, there will also be implications for bank balance sheets, a point which is discussed more fully below.) Experience in the UK indicates that this is a very important practical concern.

For any given firm, only part of the capital will be put up for auction by vouchers, usually about 40%, although in a few cases up to 80%. The remaining capital will then be available for several purposes. These include distribution to employees, although the employee ownership lobby seems to be weaker in Czechoslovakia than in Poland; hence this share, if it exists, is likely to be small. Some of the capital can be sold to foreign investors, on a basis to be decided case-by-case by the authorities (as was done with the transfer of Skoda to Volkswagen's control in December 1990). Finally, some capital can be retained for future sales to the population, once transactions in the initially distributed shares have established reasonable share prices. In this connection, it is expected that a stock exchange will be organized during 1991.

While the principle of auctions using vouchers has been accepted, its precise organization is still undecided. All Czechoslovak citizens over 18 years old will be authorized to acquire a voucher (or an investment coupon) divided into 1 000 points. It is unclear whether any fee will be paid for this voucher. One proposal is for a fee of CSK 2 000, but this would establish a very high barrier to entry. If the purpose of a fee was simply to cover the costs of auctions, a fee of only CSK 50 would be sufficient. This last proposal is also more compatible with the general intention of free distribution, which would emphasize the fairness of the process and encouraging social support for privatization.

However this issue is decided, once vouchers have been distributed citizens will apparently receive the complete list of firms to be privatized (in the particular round), with information on their activities, number of employees, previous profitability, and so on. Then auctions for shares will be organized. Two methods are being considered. Under the first, each citizen would establish a list of enterprises in which he/she was interested and at what price. The second method would involve organizing formal auctions, meetings of interested voucher holders, at which the whole or part of an enterprise's capital could be sold off using a Dutch auction system.

This programme raises many questions. The first concerns the concrete organization of the proposed auctions. In particular, the implementation of a large auction at national level seems quite unrealistic, partly for practical, administrative reasons and partly because of the likelihood of massive oversubscription for some firms and lack of interest in others. This might make the whole programme appear to be a failure, and undermine the government's entire approach to privatization.

The proposed programme comes up against severe problems of information. It will be very hard for an inexperienced

population to assess the future profitability of firms in a very uncertain environment, not least in the presence of subsidies which are bound to bias judgments. People's judgments, which will determine their future wealth, will inevitably be based on very uncertain appraisals, and if there were many mistakes the outcome could generate socially dangerous feelings of injustice and disappointment. This danger is intensified by the fact that diversification of portfolios will probably be very difficult. In this respect, the creation of mutual funds can be expected to help, but it is not clear whether they are expected to evolve spontaneously or whether the government will actively help to establish them.

Another negative aspect is the creation of a dispersed ownership which does nothing to provide strong, effective management. For, as stated in the introduction to this paper, the principal goal of privatization should be the improvement of efficiency. Even though trade in shares will begin after the implementation of each auction, lack of information, the limited domestic capital market and the dispersion of shares will hinder the emergence of shareholders with a significant share of the capital. Moreover, the government will initially retain a part of the capital. To this extent, the creation of strong managerial control might be postponed until, for instance, the intervention of a foreign investor. In this respect, the Czechoslovak programme seems to be less fully developed than the Polish one.

It is also the case that the proposed reliance on auctions ensures that the government receives very little revenue except from the 'small' privatization. Because of the already sound budget situation, however, this may be less important than in, say, Hungary, where the government has placed great emphasis on its need for revenue. In addition, there could be some danger of inflationary pressures, engendered both by the sale of shares soon after the auctions and by early distributions of dividends.[28] But the latter might well be fairly limited in the next few years (in which case, one wonders why the population should be interested in acquiring shares), while the former depends on household saving behaviour (here it is worth noting that most of the population would not understand very well that share purchases were part of their savings). With high uncertainty about the future, precautionary saving could be very important, even if longer-term expectations of an improvement in the economic situation led to a higher permanent income which might stimulate current consumption (see CEPR Report, 1990).

The more optimistic observers see April 1991 as the date for the initial implementation of the 'large' privatization in Czechoslovakia. But the unaddressed practical problems will probably delay everything by some months. Interestingly, too, some of the problems referred to above have already led to some rethinking of the vouchers scheme. Specifically, the Polish approach of combining vouchers with the development of new intermediary financial institutions (holding companies, or privatization funds) is now being considered.

6. Policy issues compared: lessons and conclusions

From the above review of the beginnings of privatization in three countries, we have seen that a number of different methods are going to be used. The 'small' privatizations in Hungary and Poland involve selling or leasing the shops and other small business establishments under local authority control, while in Czechoslovakia the same expression denotes a rather wider phenomenon, including all businesses which can reasonably be sold to a single buyer. Various forms of auction will play a part in selling or leasing these smaller businesses in all three countries. This part of the respective privatization programmes is expected to proceed relatively quickly, being substantially completed within two years. It is also expected to be generally popular. However, some delays or complications may arise from the restitution issue (whether/how to restore property to former owners), which is already a live political issue in Czechoslovakia, is becoming one in Poland and, at present, is least important in Hungary.

As regards the 'large' privatization, the transfer to private ownership of the largest State enterprises, the approaches being pursued in the three countries exhibit greater variation. Thus Hungary is committed to the British approach to privatization, with firms being transformed into joint-stock companies and their shares sold through the stock exchange or other suitable channels. At the same time, some firms will put forward their own plans for voluntary privatization, while it is also possible for third parties to make offers for Hungarian businesses. Only limited proportions of the shares in Hungarian companies will be sold to workers at a discount, or transferred to pension funds, insurance companies, and so on to form their initial capital.

[28] In the case of share sales, most transactions would involve low income people with a relatively high marginal propensity to consume selling shares to better-off people who would probably have saved in some other way, in any event. Hence there would be a net increase in consumption demand. With dividends, the position is less clear. But if shares are initially distributed fairly evenly across the population, a high proportion of dividend income would certainly be consumed too, especially in the early years.

In contrast, the other two countries both favour methods of privatization which involve the free distribution of vouchers to the population, these vouchers then being used to buy companies being privatized. In Poland, the vouchers would actually purchase companies indirectly, via newly created privatization funds; but the initial conception in Czechoslovakia involved people bidding directly for shares in individual companies (although, as indicated above, there are now signs of rethinking about this). In both countries, free distribution would be used to dispose of only about half of each company, the rest being sold in larger blocks over a longer period to ensure a sufficient concentration of share ownership to provide a strong interest in good (i.e. profitable) management of the companies concerned. Despite the variety of methods envisaged, Hungary, Poland and Czechoslovakia all expect to privatize 50 to 60% of their respective capital stocks within the next three years.

Whatever method or mix of methods is chosen, several practical issues arise. First, there is the whole complex of issues surrounding the valuation of a company being privatized (if shares are to be given away, this is not such an urgent issue, of course, except for questions of capital gains or losses), which should depend on judgments about future profitability. But profitability in turn depends on action in several other policy spheres, such as prices and taxation, credit and the treatment of outstanding debts, labour market policy, and so on. Hence in practice, especially if privatization proceeds swiftly, it will be necessary to 'guess' at suitable valuations using extremely imperfect information, so the purchase of shares will be more risky than it would normally be.

Second, once shares have been sold it is necessary to consider their marketability, through various forms of markets for financial assets. There is much discussion in Eastern Europe about establishing stock markets as soon as possible. There is, however, no particular ugency about this step, except to the extent that it is viewed as a symbolic demonstration of the commitment to market-type reform. Aside from this consideration, trading in shares (debt and equity) can be expected to take place on an informal basis at first, among a very limited number of traders (including through the banks), only gradually to develop to the volume of business at which a fully fledged stock market would be called for. However, from the point of view of potential foreign investors an effective stock market may be seen as more urgent, since a well-functioning secondary market in shares and enterprise debt facilitates exit and could thereby improve investor confidence (by reducing the perceived riskiness of investment, and hence raising the price investors would be willing to pay for shares in East European firms). To some extent, however, this point could be met by floating shares on foreign stock exchanges (as has already been done by Hungary, which floated part of the Ibusz offering in Vienna).

In all three countries studied here, the banking system is presently carrying substantial amounts of poor quality enterprise debt. Much of this will have to be written down or converted to equity in the course of privatization, and it is inevitable that the banks themselves will require financial help and restructuring in the near future as a result. If this is not undertaken very soon, the financial difficulties in the newly emerging financial sectors of Eastern Europe could seriously impede the successful and reasonably expeditious implementation of privatization programmes. This restructuring is one of the most urgent tasks in the privatization programmes of Eastern Europe, since a well-functioning banking system is a *sine qua non* for successful progress. In addition, other financial institutions such as merchant banks, insurance companies, pension funds, etc. must be developed in the near future.

Moreover, it also needs to be emphasized here that enterprise balance sheets themselves will generally require restructuring prior to privatization, a process which will, in many cases, entail the writing off of substantial enterprise debt. This is unavoidable if the newly privatized firms are to have a reasonable chance of success in open market competition, but it is an issue that has received relatively little public discussion in the debates on privatization to date.

Third, if one of the principal aims of privatization is to improve management, then it is clearly essential to specify the new management arrangements that would result from a privatization. In most cases, general (and sometimes very detailed) guidance about this is provided in the relevant company legislation in each country. The formal composition of company boards (including the extent of workers' involvement, if any), and finding suitable people for them, will be critical tasks in the next few years. In addition, the appointment of new managers (through merger, joint venture formation, board decision) is also likely to make an important contribution to improving enterprise performance.

In this connection, too, it is important to distinguish between formal ownership and effective control of the newly privatized firms. In particular, it is not enough to have a board of directors and a management structure meeting formal legal requirements, together with the usual requirement to present audited accounts and a report on the business to an annual meeting of shareholders. At least some of the shareholders should have a sufficient financial interest in the success and profitability of the business that they will take their monitoring responsibilities seriously, supporting managers

Appendix

Hungary's first privatization programme, 1990

The programme includes the following companies:

1. Centrum Department Stores

Core operating units of Centrum are being privatized by reorganization into a single joint-stock company (Rt.), the shares being held by Centrum as holding company. Foreign participation in this core company is limited to 30%. Some employee shareholding in the Centrum holding company is envisaged, and at least 40% of Centrum shares are to be issued through the Budapest Stock Exchange.

2. Danubius Hotel and Spa Company

Foreign ownership to lie in the range of 30 to 50%, shares to be sold on Budapest and foreign stock exchanges, and employees should be able to acquire 5 to 10% of the shares. Some existing debt may be converted into equity.

3. Forest Machinery Producing Company

A small company with only 180 employees, the SPA guidelines impose no particular restrictions on the method/timing of privatization.

4. Gamma Works

Main activity: production of medical and various computer/technological instruments. The company may be broken down into smaller units, and may require new technical partners; employee shareholding is to be considered. The privatization should exclude the possibility of a hostile takeover.

5. Hollóházi Porcelain Works

Possibilities of mergers, acquisitions and the identification of suitable partners (for technical, trade or investment purposes) to be explored.

6. Hungarhotels

One attempt has already been made to privatize this company, on terms considered highly unfavourable to Hungarian interests. The company became a joint-stock company in December 1989, but its registration was cancelled by the Supreme Court in March 1990. The attempt should consider whether the company should be broken up, and consider privatization in stages. A Hungarian majority stake should be maintained and, although foreign participation is welcome, there should be protection against hostile takeover. Hungarian small investors should be able to participate in this privatization.

7. Hungexpo

Main activity: organization and execution of exhibitions, and foreign trade. The aim is to privatize quickly, and identify a technical partner to support the company's marketing activities. Some employee ownership is envisaged.

8. Ibusz plc

Main business: tourism, financial services, foreign currency exchange. 40% of this company was already sold by the SPA in June 1990. The public flotation was 23 times oversubscribed. Ibusz shares are now listed in Budapest and Vienna. Note that the State retains voting control of 51% of Ibusz shares as long as it retains 33% of the issued shares. In designing this privatization, the need for a 'golden share' should be considered, as should ways of giving priority to small investors, the nature/extent of foreign involvement, the extent of employee share-ownership, and protection against takeover.

9. Idex plc

Main activity: foreign trade in industrial products.

10. Interglob Company

Main activity: road transport, international transport, freight forwarding, packing and related business. The company comprises nine operating units and two affiliates; alternative organizational structures should be considered.

11. Kner Printing Company

Main business: book printing, production of paper wrapping materials. The privatization should seek to minimize redundancies among the long-term employees of the company, and should seek to retain the production capacity of the Békescsaba factory.

12. Kunep Company

Main business: housing and social construction. The aim here is to enable the employees to own the majority of the company.

13. MÉH Scrap Processing Trust

The trust includes six regional operating units, which may need some reorganization; franchising should be examined. Employees should be able to acquire up to 10% of the shares.

14. Pannonia Hotel and Catering Company

Up to 30% foreign ownership will be allowed, and the company should be floated on the Budapest Stock Exchange, possibly after some reorganization, possibly in stages.

15. Pannonplast

Main business: production of industrial and household artificial materials (e.g. plastics). 52% of the company's assets are in various associations with foreign participation, and the company has several joint venture investments. Privatization proposals should consider how to deal with these issues. Public sale is envisaged for a minority of the shares, employees should be able to acquire 10 to 20% of the shares.

16. Pietra Building Ceramic Company

No special points to note here.

17. Richter Gedeon Chemicals plc

Main business: production of pharmaceuticals, pesticides, cosmetics and other chemicals. During the privatization, share capital is to be raised by 50%, foreign ownership can be up to 33%, and a Hungarian majority stake is to be maintained. Shares will be sold through the Budapest Stock Exchange, with 15 to 25% to be sold to small investors, 5 to 10% to be acquired by employees.

18. Salgótarján Plate Glass Factory

No special points to note here.

19. Tritex Trading Joint-Stock Company

Main activity: clothing wholesaler. Management and employee buyout considered.

20. Volántefu Company

Main activities: road transport, international transport, freight forwarding and related services. The question of whether the company needs to be split into smaller units, and the possibilities of introducing employee share-ownership are to be examined.

Note: The terms of reference for each company indicate that maximizing the State's revenue from the privatization is regarded as a high priority in determining the method/timing of each sale. In several cases, the privatization was to be designed in such a way as to guard against hostile takeovers in the future. Employee shareholding, foreign partners, and reorganization prior to privatization were to be examined in most cases. Some of the conditions placed on the above privatizations do not seem to be well designed from the efficiency standpoint.

eferences

ghion, P. and Grosfeld, I. (1990), 'De la désétatisation en urope de l'Est', in Fitonssi, J.-P. (ed.), *A l'Est en Europe*, ecial edition of Revue de l'OFCE (November).

sztalos, L. Gy. (1990), 'Bankeladások: Részesművelés', *eti Világgazdaság*, Vol. 12(37), p. 92.

abant, J. M. van (1990), *Remaking Eastern Europe — the political economy of transition*, Dordrecht, Kluwer cademic Publishers.

EPR Report (1990), *Monitoring European integration: the pact of Eastern Europe*, London.

barap, J. and Nivet, J.-F. (1990), 'Privatization in Eastern urope: the debate and the budget', mimeo, December.

akierski, H. (1986), *Economic reform and income distribution*, New York, M. E. Sharpe.

ydman, R. and Rapaczynski, A. (1990), 'Markets and stitutions in large scale privatization. An approach to onomic and social transformation in Eastern Europe', imeo.

and (1990), 'Vállalkozói hitelelek: Alapjárat', *Heti Világzdaság*, Vol. 12(40), p. 71.

rosfeld, I. (1990), 'Prospects for privatization in Poland', *uropean Economy*, No 43 (March), pp. 139-50.

rosfeld, I. (1991), 'Privatization of State enterprises in astern Europe: The search for a market environment', *astern European Politics and Societies*, forthcoming.

are, P. G. (1983), 'The beginnings of institutional reform Hungary', *Soviet Studies*, Vol. 35(3), pp. 313-330.

are, P. G. (1990), 'Reform of enterprise regulation in ungary — from "tutelage" to market', *European Economy*, o 43 (March), pp. 35-54.

Hare, P. G. (1990b), 'Transition to a market economy', *Royal Bank of Scotland Review*, forthcoming.

Hinds, M. (1990), 'Issues in the introduction of market forces in the Eastern European socialist economies', Paper for World Bank Seminar, IIASA, Laxenburg, March.

Jackman, R. and Layard, R. (1990), 'Social policy and unemployment', Working Paper No 52, Centre for Economic Performance, LSE, November.

Juhasz, G. (1990), 'Vállalati vagyonközpontok: "Ki van a tojásban", *Heti Világgazdaság*, Vol. 12(38), pp. 85-87.

Kornai, J. (1989), *Indulátos röpirat a gazdasági átmenet ügyében*, Budapest, HVG Rt.

Lewandowski, J. and Szomburg, J. (1989), 'Uwłaszczenie jako fundament reformy społeczno-gospodarczej', in *Propozycje przekształceń polskiej gospodarki*, Zeszyty Naukowe PTE, Warszawa.

Lipton, D. and Sachs, J. (1990a), 'Creating a market economy in Eastern Europe: the case of Poland', in W. C. Brainard and G. L. Perry (eds), *Brookings Papers on Economic Activity*, 1990(1), pp. 287-318 (incl. discussion).

Lipton, D. and Sachs, J. (1990b), 'Privatization in Eastern Europe: The care of Poland', mimeo.

Mora, M. (1990), 'Új csődtörvény-tervezet: Befulladásig', *Heti Világgazdaság*, Vol. 12(39), pp. 68-69.

Newbery, D. M. (1990), 'Reform in Hungary: sequencing and privatization', paper presented to fifth annual congress of the European Economic Association, Lisbon.

State Property Agency (1990), *First privatization programme 1990*, Budapest.

Szantó, A. (1990), 'Új csődtörvény-tervezet', *Heti Világgazdaság*, Vol. 12(33), p. 69.

Tardos, M. (1990), 'A privatizáció privatizációja', *Heti Világgazdaság*, Vol. 12(36), p. 66.