

# The Privatization of Central and Eastern Europe

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## 1. Introduction

A powerful wave of privatizations has swept the globe since the mid-1980s. Governments on all continents are trying to sell their companies as quickly as they can. The privatization rage has overwhelmed policymakers regardless of political conviction and has affected countries in a variety of economic circumstances. Privatization nowadays seems to be dictated less by ideology and more by efficiency and budgetary concerns. The principal objectives of privatization in most countries involved are to enhance productivity and profitability of a vast range of activities carried out by the state and to raise cash that could help plug budgetary deficits occasioned or exacerbated by recent recessionary pressures.<sup>1</sup> Privatization has raised some USD 300bn in the aggregate (not counting efficiency gains and savings from subsidy-cuts) to state coffers worldwide over the past decade. That figure, it is said, could more than double by 2000 if the privatizations in the pipeline actually reach the orifice.<sup>2</sup>

Privatization has a pivotal role to play in the transformation of the former command economies in Central and Eastern Europe. Governments in that region are in the process of transferring thousands of small, medium-sized and large state-owned enterprises (SOEs) to private owners. Others will need to be restructured or liquidated. The ambitions of the privatization programs adopted in the region extend far beyond what has been achieved to date in other parts of the world.

The purpose of this article is to provide a general overview of the Central and East European environment for privatization and to

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<sup>1</sup> In a growing number of sectors, there are also increasing competitive pressures on companies to form cross-border alliances. The private sector is reluctant to get involved with SOEs, aptly illustrated by the recently aborted proposal to merge Volvo and Renault. In the circumstances, privatization is a condition for preserving many state enterprises as competitors in the market. *See State-run groups get used to new identity*, Fin. Times, Jan. 24, 1994. *See also Europe's tired national champions*, *The Economist*, Nov. 20, 1993, at 16–17.

<sup>2</sup> *Selling the State*, *The Economist*, Aug. 21, 1993, at 16.

highlight some of the challenges governments and policymakers in the region encounter in devising coherent privatization strategies. Rather than attempting to give a detailed account of specific privatization regimes, which would almost instantly become outdated and be of little interest to a broader audience, the focus of this article is issues-oriented. The wealth of issues associated with the transformation to private ownership remains largely constant in the midst of the formidable developments rapidly unfolding in the region. Although examples are drawn primarily from the Czech Republic, Poland and Hungary, which have reached further down the road to a market-based environment than other countries in the region, the issues they serve to illustrate are valid also for many of the other reforming nations.

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## **2. Privatization and Transformation to Market Economy**

Private sector development is one of the overall objectives of market reform in Central and Eastern Europe. That development involves two concurrent changes: the autonomous expansion of the private sector and the privatization of the existing public sector. The autonomous expansion of the private sector encompasses a broad range of measures designed to *minimize government interference* in the economy, including the creation of new enterprises which are permitted to operate in a relatively unrestricted environment. In contrast, privatization often is understood as the outright *transfer of state-owned property* into private hands.<sup>3</sup> This task is critical to the success of the adopted reform programs in the region as meaningful market conditions cannot exist in the shadow of a dominant public sector. Privatization therefore constitutes an integral part of those reform programs and has a pivotal role to play in the transformation to market economy.

<sup>3</sup> The emphasis here is on the transfer of *ownership* (in whole or in part) from the public to the private sector. An alternative definition stresses the transfer to the private sector of *activities* previously carried out by the state and therefore encompasses also deregulatory measures such as "contracting out". Although a principal purpose of such measures is to improve the performance of regulated sectors, the focus is on introducing competition rather than transferring ownership. See *Organisation for Economic Co-operation and Development (OECD), Regulatory Reform, Privatisation and Competition Policy* 35–41 (1992).

Although critical to rapid transformation of reforming countries, privatization programs cannot be undertaken in a vacuum. Much attention was initially paid to the *sequencing* of individual reforms within the reform packages designed to bring about market conditions. For example, it was discussed at some length whether privatization should precede or succeed reform of the financial system.<sup>4</sup> More importantly, privatization would likely prove an impotent measure unless *property rights* are clearly defined and recognized and market participants are *allowed to organize themselves and trade freely* on the market. The same would apply unless property rights are supported by impartial, expedient and predictable *judiciary enforcement* mechanisms. It now appears that governments in the region have subscribed to the notion that reform components are tightly interlinked and that simultaneous progress on a number of counts is necessary.

Most countries in the region therefore have taken decisive measures to rid their economies of unnecessary state intervention and leave room for market forces to reign. For example, governments have gradually lifted *price controls* and reduced *price subsidies* for most goods and services. In addition, restrictions on *foreign trade* have been substantially eased. State trade organizations have lost their exclusive power to import and export and quantitative quotas have in most cases been replaced by moderate tariffs.<sup>5</sup> To support the liberalization of their foreign trade regimes, most countries have achieved *internal convertibility* of their national currencies with

<sup>4</sup> For a discussion of the phasing of reforms, see generally International Bank for Reconstruction and Development (IBRD), *The Transformation of Economies in Central and Eastern Europe: Issues, Progress and Prospects*, 16–20 (April 4, 1991) (unpublished report). See also S. Fischer & A. Gelb, *Issues in Socialist Economy Reform*, OECD, *The Transition to a Market Economy* 184, 194–97 (Vol. I, 1991), R. Dornbusch, *Strategies and Priorities for Reform*, OECD, *The Transition to a Market Economy* 169 (Vol. I, 1991) and *Don't give up now — A Survey of Business in Eastern Europe*, at 5–9, *The Economist*, Sept. 21, 1991.

<sup>5</sup> Most countries in the region have entered into free trade agreements or concluded arrangements on trade, commercial and economic cooperation with the European Free Trade Association (EFTA), the European Union (EU) and/or individual OECD countries. In addition, Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia have signed association agreements with the EU (at the time of writing both Hungary and Poland also had formally applied to join the EU). Those agreements encompass trade as well as other areas and provide a framework for harmonizing local business environments with EU norms. The trade portion of the agreements involves asymmetrically phased (to the advantage of the Central and East European signatories) reductions of tariffs and non-tariff barriers. However, the agreements have been criticized for being slow to liberalize trade in "sensitive" goods such as steel, textiles, chemicals and agricultural products which are produced competitively in the region. In fact, most countries in the region showed a *trade deficit* with OECD countries in 1993. See *Bus. E. Eur.*, Jan. 17, 1994, at 6–7. For an analysis of EU trade restrictions on imports from the region, in part superseded by the association agreements, see G. Oliver & E. Eichmann, *European Community Restrictions on Imports from Central and Eastern Europe: The Impact on Western Investors*, 22 *Law & Pol'y in Int'l Bus.* 721 (1991).

exchange rates established on the basis of supply and demand.<sup>6</sup> Also *macroeconomic stabilization* programs, including tight fiscal and credit policies, have been introduced in some countries to contain inflation and stabilize the national currency as prices and foreign trade are liberalized.

Significant measures have also been taken to develop the necessary legal and institutional infrastructure. Many countries have enacted Western-style commercial codes or companies acts to address the void of modern legislation on *business organizations*. In addition, modern *accounting* regimes have been introduced which change fundamentally the purpose of accounting from a control mechanism and a means of establishing whether an enterprise has fulfilled its role in the national plan to an instrument by which owners and managers could judge the financial condition and performance of their business. Similarly, newly enacted *tax* legislation change the function of taxation in fundamental ways.<sup>7</sup> In their quest to create competitive markets, many countries have also enacted *competition* legislation. With an eye on the EU legislation in this domain, legislators in the region generally have outlawed the abuse of dominant positions, restrictive trade practices and unfair competition. Significant developments have been made also in the *bankruptcy*, *labor* and *intellectual property* areas. The list of developments could be made much longer, but suffices to illustrate the point that recent legislative reforms have touched upon almost every aspect of human life in the region.

Despite significant developments over the past couple of years, a number of challenges remain to be overcome. One pressing task is to improve *efficiency in the financial sector* in order to clear the bottlenecks to financing expansion of private enterprise. The *banking sectors* of most countries in the region are undercapitalized and plagued with daunting bad assets problems.<sup>8</sup> In addition,

<sup>6</sup> Domestic currency convertibility for *current-account transactions*, the purchase of goods and services from abroad, is a precondition to the integration of the reforming countries' product markets into the world economy. See J. Williamson, *Convertibility*, in OECD, *The Transition to a Market Economy* 252–54 (Vol. II, 1991).

<sup>7</sup> For a principled discussion of tax reforms in the region, see generally J. Owens, *Financing Public Expenditure: The Role of Tax Reform and the Designing of Tax Systems*, in OECD, *The Transition to a Market Economy* 317 (Vol. II, 1991) and G. Kopits, *Fiscal Reforms in the European Economies in Transition*, in OECD, *The Transition to a Market Economy* 359 (Vol. II, 1991).

<sup>8</sup> Some estimates suggest 25–60% of all loans in bank portfolios could be non-performing or of a sub-standard quality. As a result, banks charge higher spreads between lending and borrowing rates to compensate for non-performing assets. This practice has had a tendency of discouraging potential borrowers and depositors as well as promoting higher-risk projects for loan approval submission. In the circumstances, bank credit to the emerging private sector has been squeezed. Recapitalization schemes and other arrangements designed to address the situation have been devised in some countries, including the establishment of "bad banks" for non-performing assets and

budget deficits in some countries gobble up resources which could have been employed in the private sector build-up. Given the scarcity of reliable business information and the low-level commercial skills of banking personnel, banks are also ill-equipped to judge the relative creditworthiness of potential borrowers. In the circumstances, the banking system is unable to satisfy the financing requirements of the emerging private sector and properly to secure efficiency in capital allocation.<sup>9</sup> The *capital markets* are presently in no position to fill the void. Although stock exchanges have opened/reopened and over-the-counter trading systems have developed in some countries, these markets exhibit considerable illiquidity and volatility as a result of their relatively limited size and efficiency.<sup>10</sup> Also the domestic markets for corporate debt provide only limited opportunities for the private sector to finance expansion. The *inflow of foreign capital* is unevenly distributed among the countries in the region. Not surprisingly, countries which still struggle with rampant inflation and stifling interest rates have been unable to attract foreign investment of any significance.<sup>11</sup> Many of these countries also suffer from political instability, which reinforces the reluctance of foreign investors to put their funds at stake.

Another urgent task that needs to be resolved concerns SOEs which are not included in the privatization programs and

swaps of such assets for government bonds or equity in privatizing SOEs. See, e.g., *Rejoined — A Survey of Eastern Europe*, at 16, *The Economist*, March 13, 1993 and *One little piggy went to market — but starved*, *The Economist*, Nov. 27, 1993, at 85.

<sup>9</sup> For a general discussion of the problems which plague the banking industry in the region and the reform challenges to policymakers, see M. Long & S. Sagari, *Financial Reform in the European Economies in Transition*, in OECD, *The Transition to a Market Economy* 430 (Vol. II, 1991). See also OECD, *Trends and Policies in Privatisation* 65–70 (Vol 1 No. 1, 1993), *Don't give up now — A Survey of Business in Eastern Europe*, at 20–24, *The Economist*, Sept. 21, 1991, *Crossing the East-West chasm*, *The Economist*, May 16, 1992, at 29–30, *Rejoined — A Survey of Eastern Europe*, at 15–17, *The Economist*, March 13, 1993 and *One little piggy went to market — but starved*, *The Economist*, Nov. 27, 1993, at 85–86.

<sup>10</sup> The Warsaw Stock Exchange, a star performer in 1993 with price increases of more than 700% in USD terms, only lists some 20 stocks and has a total market capitalization of just USD 2bn. However, a wave of new listings and share flotations are expected in 1994. See *Bus. E. Eur.*, Feb. 7, 1994, at 7–8 and A. Robinson, *Encore for a star performer*, *Fin. Times Survey: Poland*, March 18, 1994, at IV. See also A. Robinson, *Creating capitalism without capital*, *Fin. Times Survey: Emerging Markets*, Feb. 7, 1994, at 12.

<sup>11</sup> Recent estimates suggest that Hungary has attracted some USD 7bn, Poland some USD 2.8bn and the Czech Republic some USD 1.9bn in aggregate foreign investment since reforms commenced. Other countries have been less fortunate, including Romania with only USD 750m in total investments and Bulgaria with a scant USD 260m. Accumulated foreign investment is negligible in Croatia and the Ukraine, two of the more infamous basket-case economies in the region where hyperinflation pushed figures beyond 1,800% and 5,600%, respectively, in 1993. See *Bus. E. Eur.*, Jan. 17, 1994, at 3 and 5, *Bus. E. Eur.*, Jan. 24, 1994, at 4, *Bus. E. Eur.*, Jan. 31, 1994, at 5, *Bus. E. Eur.*, March 7, 1994, at 5 and *Bus. E. Eur.*, March 21, 1994, at 4. The debt accord recently struck between Poland and its commercial lenders will likely spur foreign investment into the region and provide increased access for privatized SOEs to the international capital markets.

therefore will remain in state hands for the foreseeable future. Those SOEs need to be *restructured* in order to enable governments to cut subsidies that currently drain their budgets on a massive scale and to secure free and undistorted competition with the budding private sector.<sup>12</sup> In potentially competitive sectors of the economy, much of that restructuring will be market-driven as subsidy-starved SOE managers begin to feel the pinch from increased domestic and international competition. Other sectors of the economy will probably require active government intervention on a larger scale to force restructuring. Such intervention involves a delicate balancing act between political ambitions on the one hand and economic efficiency on the other. It may be politically unfeasible to push through drastic restructuring measures within the public sector at a time when many privatized SOEs are shedding surplus personnel to secure survival and others are being forced to shut down. Governments therefore will likely continue to prop up SOEs until the emerging private sector is able to absorb the redundancies associated with public sector restructuring.

A related question involves the role of *bankruptcy* in the transformation process. Many privatizing SOEs and SOEs remaining in state hands undoubtedly are bankrupt by Western standards. Although some countries have introduced bankruptcy legislation to support the enforcement of private property rights, the number of bankruptcy proceedings in the region still is artificially low.<sup>13</sup> Fears of mass bankruptcies and ensuing mass unemployment have prompted governments and policymakers to opt for delayed implementation and/or moratoriums designed to provide temporary breathing space to struggling enterprises. Creditor banks have also been slow to push insolvent debtors into bankruptcy, partly because of fears that the unusually high level of inter-enterprise debt could trigger a chain of bankruptcies which would exacerbate the bad assets problem plaguing the banking sectors in the

<sup>12</sup> According to some statistics, direct budgetary subsidies (excluding social security, but including consumer subsidies) averaged 11% of GDP in Hungary and Poland and 16% of GDP in the Czech and Slovak Federal Republic throughout the 1980s. See IBRD, *supra* note 4, annex 5 at 2–5. For a summary of the history of subsidization in Central and Eastern Europe, see *The Search for Decentralised Socialism, The Economist*, April 28, 1990, at 9. See also D. Oliver & E. Eichmann, *supra* note 5, at 730–37 and *Cruel to be kind, The Economist*, Dec. 11, 1993, at 22.

<sup>13</sup> Only Hungary appears to have allowed a large number of SOEs to go bankrupt. Since the new bankruptcy law became effective, thousands of bankruptcy proceedings have been initiated. For a general account of the new bankruptcy law and its application in practice, see OECD, *Economic Surveys — Hungary* 80–87 (1993).

region.<sup>14</sup> Banks in some countries reportedly also have acquired large stakes in privatizing SOEs and therefore appear as creditors as well as owners. In the circumstances, incentives to enforce debts through the bankruptcy mechanism are small and contributes to an institutional bias in favor of restructuring.<sup>15</sup> The obvious dilemma is to separate the potentially viable candidates for restructuring from the duds that should be closed down and liquidated.<sup>16</sup>

The challenges described are only a few of the many colossal tasks to be tackled by governments and policymakers in the region. Other critical policy areas range from *support programs* designed to address redundancies and mitigate social tensions caused by restructuring to institutional reforms geared towards improving *tax administration and tax collection* as revenue needs climb with unemployment and the resulting demands on increased social spending.<sup>17</sup> Many of the reforms achieved to date in the region would not have been possible without policy advice, technical assistance, training and financial assistance provided or supported by a number of international organizations. Financial and technical assistance is also provided by G-24 countries on a bilateral or regional basis. International support and assistance will remain critical to reform progress in the region and will help governments to defray the costs of transformation and relieve the hardship of transition, to build the necessary market institutions and to integrate their countries into the world economy.

### 3. Privatization: Objectives, Methods and Issues

The transfer of state-owned property into private hands stands out as the most challenging aspect of the comprehensive reform

<sup>14</sup> SOEs have sought to evade the tight monetary policies introduced by many governments in the region by insisting that suppliers give them credit. As a result, inventory levels and inter-enterprise debt shot up dramatically early in the reform process. See *Buy now, pay never*, *The Economist*, May 2, 1992, at 101. See also *A second spring*, *The Economist*, Nov. 13, 1993, at 71 and *Cruel to be kind*, *The Economist*, Dec. 11, 1993, at 22.

<sup>15</sup> This is certainly the case in the Czech Republic, where banks manage many of the investment funds that own a large chunk of shares in privatized SOEs. See *A second spring*, *The Economist*, Nov. 13, 1993, at 70–71 and *One little piggy went to market — but starved*, *The Economist*, Nov. 27, 1993, at 86.

<sup>16</sup> As discussed elsewhere in this article, there is little correlation between insolvency and inefficiency of SOEs in the region. Much debt was inherited from the past and resulted from arbitrary borrowing in accordance with the centrally-imposed economic plan. This of course prompts the larger question what the proper role of bankruptcy legislation should be during the transformation process. It could be called into doubt whether bankruptcy could or should play the role it purports to do in an established market environment where the correlation between insolvency and inefficiency is strong.

<sup>17</sup> For a general review of the issues governments and policymakers encountered at the early stage of the transformation process, see OECD, *The Transformation to a Market Economy* (Vols. I and II, 1991). See also OECD's country-specific Economic Surveys.

programs adopted in Central and Eastern Europe. At the early stage of reform in the region, *thousands of SOEs* were potential candidates for privatization.<sup>18</sup> A privatization program of that magnitude had never been undertaken elsewhere in the world and little guidance could be extracted from experience.<sup>19</sup> In addition, privatizations in other regions had generally taken place in a market-oriented environment. In Central and Eastern Europe, with more than forty years of command economy and the virtual obliteration of fundamental market structures, the necessary *legal and institutional* infrastructure had to be recreated. The limited domestic *savings* in the region and the inability of the banking system or the capital markets to supply *additional financing* provided another significant constraint to governments and policy-makers.<sup>20</sup> In the circumstances, new privatization techniques had to be developed as exclusive reliance on traditional privatization methods impossibly could have reconciled the constraints imposed by the Central and East European environment with the professed desire to achieve rapid transformation to market economy.

### 3.1 Principal Policy Objectives

Governments in the region almost universally profess allegiance to the overall objective of reducing state intervention in economic decision-making and creating market-based incentives. In this perspective, privatization is often seen as the principal means of rapidly shrinking the public sector and therefore also as a fundamental ingredient in the adopted market reform-programs. Privatization, it is hoped, will yield improved economic efficiency and create a share-owning middle class as a basis for the new democratic order. Another often cited policy objective of privatization is

<sup>18</sup> According to some estimates, there were some 13,000 large SOEs in total only in the Czech and Slovak Federal Republic, Hungary and Poland at the early stage economic reforms. In addition, small businesses numbering hundreds of thousands were slated for small-scale privatization in those countries alone. See OECD, *Methods of Privatising Large Enterprises* 135–36, 160 (1993) and OECD, *Trends and Policies in Privatisation* 40 (Vol. 1 No. 3, 1994). See also OECD, *Economic Surveys — Czech and Slovak Federal Republic* 138 (1991).

<sup>19</sup> To appreciate the significance of the large number of SOEs that were to be privatized in Central and Eastern Europe at the early stage of reforms, fewer than 1,000 firms were privatized throughout the world between 1980 and 1987. The Thatcher regime in England carried out one of the most celebrated privatization programs to date, involving the sale of some 20 SOEs which accounted for approximately five percent of value added. See IBRD, *supra* note 4, at annex 2. See also *Don't give up now — A Survey of Business in Eastern Europe*, at 10, *The Economist*, Sept. 21, 1991.

<sup>20</sup> The savings that do exist are sometimes perceived to be inequitably distributed and fairness considerations will therefore figure prominently. See D. Lipton & J. Sachs, *Privatization in Eastern Europe: The Case of Poland*, 1990 *Brookings Papers on Economic Activity* 293, 323–26. See also F. Dhanji & B. Milanovic, *Privatization in Eastern and Central Europe* 12–13 (World Bank 1990). A revised version of that paper appeared in OECD, *The Transition to a Market Economy* (Vol. II, 1991).

to raise revenues to empty state coffers, almost instantly by generating privatization proceeds and reducing the burden of inefficient SOEs on the state budget and long-term by improving the tax base as the economy shifts into a higher gear.<sup>21</sup>

Although universal acceptance of privatization as such seems to be within reach, the masters of privatization policy in the region have faced enormous challenges in their attempts to devise coherent strategies. The overall efficiency, democracy and revenue objectives described above provide little guidance for architects of policy implementation. Rather, the details of privatization programs are shaped by institutional constraints and the characteristics of the countries involved. Three aspects seem particularly important in this context. First, the tremendous number of SOEs to be shifted to private ownership requires techniques that are faster than are traditional privatization methods. A focus on *rapid privatization* therefore seems inevitable.<sup>22</sup> Second, the programs need to secure an *effective structure of corporate governance* post-privatization. This is critical in view of the massive operational and financial restructuring required in order to resuscitate much of the region's moribund industry. Third, any privatization strategy must be perceived by the public as *fair and beyond reproach* in order to secure the necessary political support.<sup>23</sup>

It is clear that the stated objectives and requirements are not entirely compatible. For example, rapid privatization may be difficult to reconcile with operational efficiency post-privatization. Mass distribution schemes undoubtedly provide a fast-track to private ownership, but might fail to foster an effective structure of corporate governance. With shares of privatized SOEs spread too thinly on too many hands, it is argued, investors will have neither the incentive nor the strength to push through the necessary restructuring measures and/or monitor management perform-

<sup>21</sup> For a general discussion of the policy objectives of privatization, see F. Dhanji & B. Milanovic, *supra* note 20, at 1–6. A recent World Bank study supports the proposition that privatization improves performance, creates incremental wealth and distributes benefits to investors, governments and customers in a fairly equitable way. For a summary of the findings, see *Escaping the heavy hand of the state*, *The Economist*, June 13, 1992, at 61–62.

<sup>22</sup> The case for rapid privatization has been advanced by a number of scholars, but perhaps most vigorously by D. Lipton and J. Sachs. See D. Lipton & J. Sachs, *supra* note 20, at 296–99. See also *Don't give up now — A Survey of Business in Eastern Europe*, at 6, *The Economist*, Sept. 21, 1991 and *Eastern Europe hesitates*, *The Economist*, May 16, 1992, at 13–14.

<sup>23</sup> The dependency on political support is at the core of the argument in favor of rapid privatization. Unless a large number of SOEs are quickly brought into the privatization process, the argument goes, the political battle over privatization could soon lead to a stalemate of the entire process. This would jeopardize the necessary restructuring of SOEs and substantially delay the transformation to market economy. See, e.g., D. Lipton & J. Sachs, *supra* note 20, at 297–99.

ance.<sup>24</sup> The concern is particularly valid in Central and Eastern Europe where the level of management skills is low and the market for corporate control diminutive. Rapid privatization also may be difficult to reconcile with revenue contribution to the state budget. Given the modest level of domestic savings in the region, sales at market values to local investors are clearly at odds with a speedy conclusion of privatization. In addition, the obvious shortcomings of traditional valuation techniques and the absence of reliable business information would likely impact negatively on the interest of local investors to participate in such a program. The alternative, to allow cash-rich foreign investors to dominate the privatization process, would in most countries be politically unthinkable.

All countries in the region have adopted a multi-track approach to privatization. A variety of different privatization methods coexist in most countries. However, the *focus* of the programs adopted differs from one country to another and reflects the relative weight authorities have ascribed to relevant political, economic and social factors. An illustration of the different approaches to privatization adopted by some of the countries in the region will follow.

### 3.2 Preparation for Privatization

The industrial sector was the centerpiece of the former policy of economic development in the region. In furtherance of this policy, the focus was set on the heavy manufacturing industry and very large enterprises were promoted.<sup>25</sup> It is therefore not surprising that many SOE's in the region show a high degree of *vertical integration* and often wield substantial *market power* in the domestic market.<sup>26</sup> In addition, years of under-investment in modern and competitive technologies and a political focus of prior regimes on full employment have resulted in an industry characterized by *outdated equipment and technologies* and a high degree of *overstaffing*. Many SOEs also have a *level of debt* which would make them bankrupt in a market-based environment. The list of problem areas could be made much longer, but suffices to illustrate the point that many SOEs enjoy dominant market positions in their

<sup>24</sup> For a discussion of the corporate governance issues involved, see D. Lipton & J. Sachs, *supra* note 20, at 313–21.

<sup>25</sup> In the mid-1980s some 50% of Polish industrial SOEs and some 70% of Soviet industrial SOEs had in excess of 1,000 employees. The corresponding figure for the industrial sector in the United States was some 25%. See Fin. Times Survey: The Reforming of Russia, May 13, 1992, at IV. See also D. Lipton & J. Sachs, *supra* note 20, at 301–02.

<sup>26</sup> Many of the larger SOEs not only produce goods and services, but also provide a wide range of highly subsidized *social services* to their workers. Those services may include housing, holiday accommodation, medical and dental services and child care to mention the most prevalent.

domestic markets, require a fair amount of operational and managerial restructuring in order to become economically viable and are burdened by debts which would jeopardize their existence in a market environment.

Apart from the customary transformation of SOEs into joint-stock companies or similar corporate entities pre-privatization (a process sometimes referred to as "commercialization"), authorities have to decide on the steps, if any, to be taken to restructure the SOEs before they are privatized.<sup>27</sup> It is sometimes argued in favor of *demonopolization* that it would make little sense to replace state monopolies with private ones.<sup>28</sup> However, the break-up of state monopolies is a task which is difficult and time-consuming and requires substantial technical expertise. Although governments in the region subscribe to pro-competitive policies, active demonopolization pre-privatization may be incompatible with rapid privatization. In addition, the great majority of SOEs operate in potentially competitive sectors of the economy and are likely to come under competitive pressures as barriers of market entry are relaxed or eliminated. In the circumstances, some countries appear to place considerable reliance on market forces to do the job and concentrate on preventing abuses of dominant market positions or other illicit behavior post-privatization.<sup>29</sup> A significant role in that process will be to foster market ethics, attitudes and

<sup>27</sup> A significant purpose of the transformation of SOEs into joint-stock companies or similar legal entities is to eliminate the powers of workers' councils and other constituents and separate the SOE activities and decision-making from the traditional bureaucratic hierarchy of economic administration. Although employees and other constituents sometimes are represented on the supervisory board (or board of directors) of the transformed entities, the process in effect deprives them of their special privileges acquired during communist rule. It is therefore important that the process of transformation is outside the control of the SOEs themselves. For a discussion of the role of workers in the privatization, see generally D. Lipton & J. Sachs, *supra* note 20, at 308-09.

<sup>28</sup> See, e.g., M. Reynolds, *The Role of Competition Law in Central and Eastern Europe*, (1992) 20 *Int'l Bus. Law*. 510. The argument could be challenged as private monopolies are likely to have stronger incentives to improve efficiency and create wealth gains than are public monopolies. Society should be able to capture some of those gains through a higher purchase price in a competitive privatization sale. Vigorous prosecution of outlawed abuses and the downturn in domestic demand will likely temper exploitation of monopolistic powers in the short term. In addition, over time trade liberalization will erode the dominant position of many monopolies in potentially competitive sectors of the economy.

<sup>29</sup> The Czech Republic is an example. Here *spontaneous* break-ups have occurred in the privatization process. That process allows for competing proposals (or "projects" in Czech parlance) to be submitted, also projects for part of a privatizing SOE. If one project proposes privatization of the whole of an SOE and another project proposes privatization of a part only, in general, the latter will be selected if such part and the remaining part of the SOE create a separate functional whole and such separation does not threaten the capability of the remaining part to be privatized. See Czech Republic Guidelines for Further Progress in Privatization under Act 92/1991 and Act 171/1991 as amended.

habits conducive to free and fair competition. In contrast, other countries seem to have adopted a more centralized or managed approach to demonopolization.<sup>30</sup>

Advocates of pre-privatization *operational restructuring* often argue that unstructured SOEs will yield less revenues to the state coffers than restructured ones. This is undoubtedly true, but may not matter much. It is unlikely governments could recoup the restructuring investments that would be necessary in order to prepare SOEs for privatization.<sup>31</sup> In addition, substantial pre-privatization restructuring again may be difficult to reconcile with a desire to privatize quickly. Most importantly, though, privatization authorities rarely have the personnel or know-how to do the job. Although governments could and do retain external expertise to advise on restructuring matters, potential or actual investors are normally better suited to gauge the restructuring needs of a particular firm as they may contemplate substantial investment programs to upgrade outdated plant, machinery and equipment. Redundancies ensuing from restructuring of privatizing SOEs may also be difficult to handle politically if they occur while the SOEs are still in state hands. In the circumstances, most governments have shied away from active operational restructuring and limited their involvement to *ad hoc* spin-offs from large SOEs necessary to create saleable business entities. Only the Polish authorities appear to have engaged in substantial pre-privatization operational restructuring.<sup>32</sup> Post-privatization

<sup>30</sup> The Polish government appears to have adopted a more centralized approach. In its sectoral program pre-privatization studies covering some 30 sectors of the economy have been or are being carried out by foreign advisors appointed to assess the saleability and value of the SOEs in each sector. Advisors determine whether an SOE should be privatized immediately, restructured or liquidated. The sectoral approach should also facilitate an assessment of structural issues impacting on competition and enable authorities to address any monopoly concerns more effectively. For a brief account of the Polish sectoral approach, see S. Denyer & P. Symes-Thompson, *Competing in the Privatisation Game, Int'l. Corp. L.*, Oct. 1992, at 19–21. See also *Selling by sectors, The Economist*, Sept. 28, 1991, at 91 and A. Robinson, *Taking politics out of economics*, Fin. Times Survey: Poland, June 17, 1993, at VI.

<sup>31</sup> See F. Dhanji & B. Milanovic, *supra* note 20, at 11. Given the budget deficits of many countries in the region, it is also unlikely governments could afford to make the broader-scale investments in the first place. See, e.g., *Eastern Europe hesitates, The Economist*, May 16, 1992, at 13.

<sup>32</sup> The Polish government reportedly has engaged in pre-privatization operational restructuring of some 300 SOEs. In the former GDR, SOEs not yet sold are being actively restructured or liquidated. Also the Hungarian government reportedly plans to become more involved in pre-privatization restructuring. It approved in 1992 a program of crisis management and restructuring for a dozen large industrial SOEs. The program is designed to preserve industrial employment in firms that have reasonable long-term prospects for success. See OECD, *Trends and Policies in Privatisation* 14–15 (Vol 1 No. 3, 1994) and OECD, *Economic Surveys — Hungary* 113–14 (1993). See also *Any offers?*, *The Economist*, March 27, 1993, at 84–85.

restructuring will therefore inevitably play a significant role in the transformation process in most countries.

It is occasionally suggested that some measure of pre-privatization *financial restructuring* should be taken by governments to clean up balance sheets of privatizing SOEs. The arbitrary nature of lending under communist rule (lending was made in accordance with state plans and terms did not reflect risk) produced a situation where there is no or little correlation between insolvency and inefficiency. Many of the SOEs with the heaviest debts could also be among those able best to survive in a market environment. Conversely, many of the SOEs with the lightest debt-burden could be among the ones doomed to succumb to the forces of free competition. In the circumstances, there is a possibility that potentially viable (but heavily indebted) SOEs may suffocate under their mountains of debt and that SOEs with no long-term prospects (but with few debts) may keep afloat until submerged by new losses.<sup>33</sup> Although often empowered to write off debts of privatizing SOEs, governments generally appear to have adopted an *ad hoc* approach to financial restructuring and to leave the financial restructuring to banks and other creditors post-privatization. Only Treuhandanstalt (the state agency charged with administering the sale of state property in eastern Germany) has provided widespread relief to SOEs put up for privatization by eliminating or reducing their debts prior to unloading the SOEs on investors.<sup>34</sup>

### 3.3 Privatization Methods

Privatization, in the technical and limited sense, is carried out through a variety of methods.<sup>35</sup> The avenues utilized depend on the nature of the assets put up for privatization and pundits often distinguish between small-scale and large-scale privatizations. The former category is usually said to involve privatization of land, buildings and other agricultural and/or residential assets as well as small and medium-sized SOEs (or units of large SOEs) engaged in retail, trade, services or similar activities. In contrast, the latter category typically involves the privatization of large SOEs (often

<sup>33</sup> See *Don't give up now — A Survey on Business in Eastern Europe*, at 23, *The Economist*, Sept. 21, 1991.

<sup>34</sup> See, e.g., OECD, *Trends and Policies in Privatisation* 14 (Vol. 1 No. 3, 1994). The revenues of a privatization sale naturally reflect the financial position of the privatized SOE. Everything else being equal, an SOE with few debts will generate more revenues than a heavily indebted SOE. The approach of leaving financial restructuring to the new owners is therefore in effect tantamount to a debt write-off.

<sup>35</sup> For a survey of legal techniques of privatization, see J. Robert, *Law and Privatisations — A General Presentation of Issues*, in *Council of Europe, Legal Aspects of Privatisation* 17 (1993), and T. Daintith, *Legal Forms and Techniques of Privatisation*, in *Council of Europe, Legal Aspects of Privatisation* 50 (1993).

manufacturing combines). Small-scale privatizations are often carried out separately from programs designed to privatize large SOEs. Although there are no clear-cut lines between small-scale and large-scale privatizations, some countries have applied tests based on employment levels, assets values, activity types and similar criteria.

Small-scale privatizations are often carried out through auctions. In these auctions price is the sole or principal determinant and leasehold interests (sometimes with future options to purchase) rather than ownership property are often auctioned off to the highest bidder. Management/employee buyouts are also a popular means of privatizing small and medium-sized SOEs. This avenue appears to be the predominant method of privatization in Russia and Romania, where management/employee buyouts reportedly account for some two-thirds of all privatizations to date.<sup>36</sup> Management/employee buyouts have made a significant contribution to privatization also in Poland, where management and/or employees often acquire the business following liquidation of their SOE. This method of "privatization through liquidation" reportedly accounts for one-third of all privatizations to date in that country.<sup>37</sup> Also restitution of previously confiscated property (sometimes referred to as "reprivatization") has proved an important method to transfer state assets into private hands.<sup>38</sup>

The simplicity and low-profile character of small-scale privatizations make them politically and administratively much easier to handle than the privatization of large SOEs. In addition, the operational and financial restructuring required post-privatization in small and medium-sized SOEs naturally is on a smaller scale than the sometimes monstrous overhaul awaiting larger SOEs. Thus, the identity of the investor is less significant in small-scale privatizations than in large-scale privatizations and the breadth of

<sup>36</sup> See, e.g., OECD, *Trends and Policies in Privatisation* 40–41 (Vol. 1 No. 3, 1994). The statistics understate the extent of management/employee participation in the Russian privatization as the management/employees may acquire minority and/or non-voting stakes which are not accounted for.

<sup>37</sup> This method involves liquidation in name only, and is really an assets transaction. In the majority of instances where this method has been employed, the assets of the business have been leased to the management/employees. See J. Szomburg & P. Tamowicz, *Employee and Management Buy-Outs in Polish Privatization*, in OECD, *Trends and Policies in Privatisation* 175, 176 (Vol. 1 No. 3, 1994). See also *If it works, you've fixed it*, *The Economist*, Jan. 23, 1993, at 25.

<sup>38</sup> Most countries in the region have addressed or are seeking to address claims from prior owners of property expropriated under communist rule. Although the details of the adopted restitution/compensation schemes differ from one country to another, the tendency is to avoid large-scale restitutions and offer the victims *financial compensation* instead (although restoration to the former owners often is permitted under limited conditions). The principal objective of this approach is to dispel any uncertainty surrounding the ownership of assets put up for privatization.

potential investors therefore is much wider in small-scale privatizations. In the circumstances, it does not come as a surprise that small-scale privatizations have made significantly more progress than the privatization of large SOEs.<sup>39</sup> The success of small-scale privatizations is critical to the overall progress of the reforms and is the first visible sign of change to an impatient population. Small and medium-sized businesses will absorb some of the surplus personnel catapulted into unemployment as SOEs are restructured and/or closed down. In addition, small and medium-sized businesses play a pivotal role in the distribution of basic goods and services and will likely become net contributors to government budgets (through the payment of taxes) much faster than their larger counterparts.

In contrast to small-scale privatizations, the privatization of large SOEs is a complex affair and the process is often protracted. Given the capital and restructuring needs of many large SOEs, the identity and capabilities of the investors grow in importance. In addition, some of these SOEs are high-profile household names and employ a significant slice of the adult population in the communities where their operations are located. For these and other reasons, large-scale privatizations typically are considerably more delicate politically than small-scale privatizations and require decision-makers to balance a number of interests (sometimes conflicting) in the process.<sup>40</sup> There are several different methods available to privatization authorities in Central and Eastern Europe. Among the most frequently encountered are mass privatization, trade sales and initial public offerings.

Most countries in the region have turned to *mass privatization* as a means of severing the links between the state and large SOEs. This method involves the distribution of shares of SOEs, or vouchers which could be exchanged for such shares, to the population. The shares or vouchers are usually distributed for free, although nominal consideration applies in some countries. Speed is the principal advantage of mass privatization and, given the mind-boggling number of large SOEs to be privatized, the method is probably a necessary ingredient in any earnest attempt to achieve

<sup>39</sup> Many countries in the region either have completed or are about to complete their small-scale privatization programs. For a comparative review of small-scale and large-scale privatization developments in the region, see OECD, *Trends and Policies in Privatisation* 29–38 (Vol. 1 No. 3, 1994).

<sup>40</sup> A general overview of some of the more critical issues in large-scale privatization is provided by H. Blommestein, R. Geiger & P. Hare, *Privatising Large Enterprises: Overview of Issues and Case Studies*, in OECD, *Methods of Privatising Large Enterprises* 11 (1993). See also S. Zecchini, *Critical Issues in Privatisation*, in OECD, *Methods of Privatising Large Enterprises* 71 (1993).

rapid transformation to market economy. In addition to providing a fast-track to private ownership, mass privatization largely obviates valuation and therefore by-passes the valuation problems normally associated with trade sales (described below). The method also involves broad-based domestic participation in the privatization process and is likely to score high marks from a fairness perspective. Advocates of mass privatization also point out that mass privatization instantly creates a broad-based property-owning middle class and therefore could help underpin democracy and political stability in the region.<sup>41</sup> It could also be assumed that the technique, being a relatively transparent process, is less susceptible to charges of corruption and therefore politically easier to handle than are individually negotiated transactions.

The details of the mass privatization programs adopted in the region differ in significant respects from one country to another. Some countries have taken an aggressive approach to mass privatization and included a significant chunk of their large SOEs in the program, whereas other countries have threaded more carefully and only included a selected few. For example, the Russian mass privatization program requires all large SOEs (satisfying certain employment and assets value criteria) to participate in the program and sell a stipulated minimum percentage of their shares through the voucher scheme. Similarly, it is estimated that more than 30% of the SOEs privatized to date in the Czech Republic were offered to the public through the mass privatization program and that vouchers were used to acquire more than 80% on average of the equity in the privatizing SOEs included in the program.<sup>42</sup> In contrast, the proposed Polish mass privatization program is of a much more modest nature and only targets 400–600 large SOEs. Although proposed already in 1991, progress has been stalled in parliament which only recently gave its approval to the program.<sup>43</sup> Similarly, Hungary only recently turned to mass privatization under pressures to expedite the process of transferring the state sector into private hands. The Hungarian program, which differs in material respects from other programs adopted in

<sup>41</sup> See, e.g., F. Dhanji & B. Milanovic, *supra* note 20, at 4–5.

<sup>42</sup> See OECD, *Trends and Policies in Privatisation* 34, 45 (Vol. 1 No. 2, 1993) and OECD, *Trends and Policies in Privatisation* 31, 40 (Vol. 1 No. 3, 1994). For a popular description of the Czech voucher privatization scheme, see *Going for broke*, *The Economist*, May 16, 1992, at 91–92 and *Casino capitalism*, *The Economist*, Sept. 12, 1992, at 73–74.

<sup>43</sup> See Law on Investment Funds and Their Privatization (April 30, 1993) [hereinafter the "Polish Mass Privatization Law"].

the region and yet remains to be implemented, also targets a limited number of SOEs to be offered to the public.<sup>44</sup>

One of the principal shortcomings of the mass privatization approach is that it might fail, as noted, to foster an effective structure of *corporate governance*. In the absence of a functioning market for corporate control, there is a risk that a dispersed ownership structure of privatized SOEs may perpetuate the old ways of doing business, entrench existing management and delay the much-needed restructuring. A number of SOEs that could have been made viable may therefore succumb as bankruptcy legislation begins to bite. Governments and policymakers are very much aware of this danger and various solutions have been proposed to address the concern. Although the details of the proposed solutions vary from one country to another and reflect the relative confidence of governments and policymakers that market forces could do the job, the essence is akin in all countries which rely heavily on mass privatization.<sup>45</sup> By interposing intermediary investment funds between the share-owning public and privatized SOEs, governments and policymakers in the region hope to consolidate control and facilitate corporate governance. In addition to providing diversification for individual investors, the investment funds are expected to exercise active ownership aimed at restructuring privatized SOEs and moving them into profitable

<sup>44</sup> Unlike other mass privatization schemes in the region (which largely are mass give-away schemes), the Hungarian approach contemplates that SOEs put up for privatization be sold rather than distributed through vouchers. Under this scheme local investors will be offered non-recourse and interest-free loans to finance the purchase of shares in SOEs. The non-recourse aspect seems to limit recovery to the shares purchased (in effect a put option for the investor to sell to the state at the value of the outstanding debt) and therefore brings the scheme dangerously close to the mass give-aways proposed or implemented elsewhere in the region. See, e.g., OECD, *Economic Surveys — Hungary* 75–79 (1993) and N. Denton, *Utilities take up the torch*, *Fin. Times Survey: Hungary*, Nov. 17, 1993, at 3–4.

<sup>45</sup> For example, the Czech government has adopted a thoroughly market-based approach, whereas the Polish government has taken a more managed stand. Spontaneously organized investment funds played a significant role in the first wave of the Czech mass privatization program. Some 250 funds drew more than 70 percent of all the vouchers in circulation and now own a significant portion of the shares of privatized SOEs. In contrast, the Polish mass privatization program contemplates that some 60 percent of the shares of the SOEs included in the program will be distributed to some 20 national investment funds to be created, with a sizeable chunk of the shares allotted to one fund (lead fund). Investment certificates (shares in the investment funds) will then be distributed to the adult population. See Art. 10 of the Polish Mass Privatization Law. See also OECD, *Trends and Policies in Privatisation* 32–33, 43–45 (Vol. 1 No. 1, 1993), OECD, *Trends and Policies in Privatisation* 34–35 (Vol. 1 No. 2, 1993), and *Making it work*, *The Economist*, March 13, 1993, at 88–89.

territory.<sup>46</sup> It remains to be seen whether the investment funds are able to perform this role.<sup>47</sup>

As opposed to mass distribution of shares or vouchers, *trade sales* involve the sale of SOEs to one or more specific investors or investor groups. Trade sales could take a number of different forms, including public or closed tenders, direct sales or auctions. One principal advantage of trade sales is that they produce more revenues for contribution to the state budget than does mass privatization.<sup>48</sup> Trade sales also allow authorities to secure a stable core of investors with capabilities to carry out the much-needed post-privatization restructuring and to extract from them a number of contractual commitments pertaining to the post-privatization operation of the privatized SOEs. Commitments commonly sought by authorities in negotiations with investors (particularly foreign investors) include undertakings to upgrade outmoded plant, machinery and equipment, to make additional equity contributions and/or providing or guaranteeing additional debt financing, to transfer state-of-the-art technology to the privatized SOEs, to provide training and other management support designed to bring the necessary managerial skills to the top-level SOE personnel, to provide the privatized SOEs with access to the investor's international marketing and distribution network and to maintain a specified level of employment in the privatized SOEs for a period following the privatization.

The method of trade sales has been the norm only in Germany and Hungary. Although trade sales have occurred also in other countries, the technique has assumed a relatively modest role in

<sup>46</sup> For a general discussion of the role of commercial banks and other financial intermediaries in the privatization process, see OECD, *Trends and Policies in Privatisation* 65–84 (Vol. 1 No. 1, 1993).

<sup>47</sup> The investment funds rarely have the capital or the skills required in order properly to restructure the SOEs in their portfolios. It could therefore be expected that the funds will team up with outside investors which could provide the necessary resources. In the absence of a secondary market for corporate control, the investment funds could be helpful in consolidating control with long-term investors capable of carrying out the necessary restructuring. However, given the dispersed ownership structure of the investment funds, corporate governance issues may arise also at that level as market pressures may be unable to create the necessary incentives for fund managers to maximize shareholder value. The Polish privatization program seeks to address that problem by introducing performance-based compensation for fund managers at the end of the envisaged ten-year initial life of the investment funds. See Arts. 21–23 of the Polish Mass Privatization Law. See also A. Robinson, *Taking politics out of economics*, Fin. Times Survey: Poland, June 17, 1993, at VI, and *Poland 4th quarter 1993*, EIU *Business Report* 80 (1993).

<sup>48</sup> Also mass privatization could contribute to the budget as long as the program is accompanied by strictly enforced subsidy cuts once the umbilical cord between the state and privatizing SOEs is severed.

the adopted privatization programs.<sup>49</sup> In Germany nearly 13 000 privatization transactions had been completed by mid-1993.<sup>50</sup> Treuhandanstalt has relied primarily on direct sales to Western (mostly German) investors in reaching this record sales volume. Given the immense advantages in terms of a common language, political stability and a well-developed legal and institutional infrastructure characterizing the privatization context in Germany, Treuhandanstalt's achievement probably approaches the limits for what is humanly possible. Progress in Hungary has been significantly slower. By mid-1993 close to 300 SOEs had been privatized through trade sales, representing some 80 % of the then privatized book value.<sup>51</sup> In view of the relative scarcity of financial resources in the country, privatization authorities have courted primarily foreign investors to put up the funds. Many of the best SOEs in Hungary have already been acquired by or joined forces with foreign investors. The remaining lot may be less appetizing for investors and the privatization process has ground to a virtual halt as a result.<sup>52</sup> In response to criticism over the slow pace of privatization and the foreign bias in the privatization process, authorities recently advanced a scheme for mass privatization referred to above.

Although trade sales provide authorities with a powerful instrument to influence the outcome of the privatization process and extract contributions to the state coffers, they also present policy-makers with formidable challenges. The process of trade sales is generally *slower* than that of mass privatization and requires a larger number of qualified personnel to administer negotiations with potential investors.<sup>53</sup> In addition, fairness dictates that sales of

<sup>49</sup> The Czech Republic is perhaps an exception. In that country, trade sales accounted for some 50 percent of all transactions completed by mid-1993. However, trade sales only represented ten percent of the total book value then privatized. See OECD, *Trends and Policies in Privatisation* 16 (Vol. 1 No. 3, 1994).

<sup>50</sup> See *id.*, at 13.

<sup>51</sup> See *id.*, at 16, 40.

<sup>52</sup> See OECD, *Economic Surveys — Hungary* 68–72 (1993). See also N. Denton, *From infancy to mid-life crisis*, Fin. Times Survey: Privatisation in Eastern Europe, July 3, 1992, at IV, and N. Denton, *Utilities take up the torch*, Fin. Times Survey: Hungary, Nov. 17, 1993, at 3–4.

<sup>53</sup> In an attempt to reconcile a severe shortage of qualified personnel with the adopted focus on individual transactions, the Hungarian State Property Agency (SPA) has delegated some of the privatization tasks to the SOEs themselves and/or external advisors. For example, SPA launched a self-privatization program in 1991 under which small and medium-sized firms may privatize themselves with the aid of advisors pre-authorized by SPA. The pre-authorized advisors manage the process by performing the valuations, choosing the method of privatization, collecting bids and selecting the buyer. Although SPA's approval is formally required in the end, it is said to accept the outcome if the procedures for self-privatization have been complied with. See OECD, *Economic Surveys — Hungary* 70 (1993) and OECD, *Trends and Policies in Privatisation* 134 (Vol. 1 No. 2, 1993).

SOEs to targeted investors be effected at market values. This is problematic as *valuation* of SOEs in the region is an exceptionally imprecise exercise. The virtual absence of reliable business information (often as a result of poor record-keeping) presents overpowering obstacles and the unprecedented metamorphosis from command economy to market-based structures currently underway in the region underscores the irrelevance of much historical data that nevertheless can be extracted.<sup>54</sup> Further, the often limited *savings* in the region make it difficult to reconcile sales at market values with broad-based domestic participation and rapid privatization (although "soft" financing arrangements and/or installment payment plans are often available). The method of trade sales also tends to be less *transparent* than other privatization methods. Although applicable privatization legislation often mandates competitive tenders as a means of increasing transparency in the privatization process, that procedure is best suited for small-scale privatizations where price frequently is the sole or principal determinant. However, the privatization of larger SOEs requires a different set of considerations to be applied. Given the massive restructuring often required to turn those SOEs into profitability, authorities also have to assess investment and restructuring plans, technology transfers, investor reputation and international market access to mention a few areas of concern. This assessment is largely discretionary and therefore susceptible to criticism *ex post facto*.

Initial *public offerings* have often been used in Western privatizations as a principal means of transferring SOEs into private hands. However, the method's overall impact on the privatization of SOEs in Central and Eastern Europe remains limited. Only few countries have used initial public offerings as a privatization method and the number of flotations is negligible in the overall context.<sup>55</sup> In view of the relative illiquidity and volatility of the recently opened/reopened stock exchanges in the region, the scarcity of domestic financial capital and the poor historical performance of most SOEs put up for privatization, the limited role to date of initial public offerings is hardly surprising. In addition, the costs of preparing SOEs for listing on the stock exchanges coupled with relatively stringent listing requirements render the avenue of stock exchange flotation a dead end for all SOEs but a select few.<sup>56</sup>

<sup>54</sup> For a general discussion of the valuation problems associated with appraisals in the region, see OECD, *Valuation and Privatisation* (1993).

<sup>55</sup> See OECD, *Trends and Policies in Privatisation* 36, 40 (Vol. 1 No. 3, 1994).

<sup>56</sup> This was early recognized by Treuhandsanstalt in Germany, where capital markets and settled regulation were already in place at the time privatization began. See M.

The significance of stock exchanges is bound to increase as foreign portfolio investors continue to pour funds into the region, listing privileges are extended to a larger number of shares and overall professionalism and supervision are enhanced.<sup>57</sup> It could be expected that the recent surge in share prices on some of the stock exchanges in the region will attract listing applications from an increasing number of privatized SOEs in search of cheap equity financing. The stock exchanges in the region may also provide a convenient vehicle for offerings to the public of minority stakes initially retained by the state in partially privatized SOEs. An increased interest in listed shares will also spur the generation of high-quality financial analyses and improve the overall flow of reliable business information to the markets. Despite expected improvements in the efficiency of the securities markets in the region, the overall impact of stock exchanges in the privatization process will likely remain limited. In the circumstances, one of the most important functions of the stock exchanges in a medium-term perspective will be to contribute to the consolidation of ownership and control in mass-privatized SOEs.<sup>58</sup>

### 3.4 Institutional Aspects

All countries in the region have established privatization-specific institutions with broad powers to formulate and implement privatization policies. However, the *institutional set-up* differs significantly from one country to another. Although a central privatization authority is a common denominator, the powers vested in and/or exercised by that authority reflect the relative influence of the various stake-holders in the process and the degree of the privatization authority's independence.<sup>59</sup> Some countries have opted for a concentrated approach to decision-making, whereas others have elected to spread the powers among a number of different institutions. A concentrated approach to decision-making naturally tends to generate less political infighting and fewer institutional

Bracklo, *Buy-Outs and Buy-Ins as Privatization Mechanisms in Central and Eastern Europe*, in OECD, *Trends and Policies in Privatisation* 93 (Vol. 1 No. 3, 1994).

<sup>57</sup> Foreign portfolio investment over the stock exchanges in the region increased dramatically in 1993. For example, it is estimated that foreign investment currently accounts for some 20–25% of the market capitalization of the stock exchange in Warsaw. See *Bus E. Eur.*, Feb. 7, 1994, at 7–8.

<sup>58</sup> See OECD, *Trends and Policies in Privatisation* 17 (Vol. 1 No. 3, 1994).

<sup>59</sup> The background is that the rights normally associated with ownership (e.g. the right to use, the right to earnings and the right to dispose of) are *vaguely distributed* among state and municipal bureaucracies, workers and SOE managements. See D. Lipton & J. Sachs, *supra* note 20, at 302–04. For a discussion of the principal institutional aspects, see S. Nestor, *Institutional Aspects of the Privatisation Process in Central and Eastern Europe: Overview of the Main Issues*, in OECD, *Trends and Policies in Privatisation* 87 (Vol. 1 No. 2, 1993).

bottlenecks than do arrangements of a dispersed nature. In addition, the former approach is more likely to secure transparency in the privatization process.

The role of SOE management/employees in the privatization process is of particular interest. At the outset of economic reform in the region, workers in some countries had substantial influence over the operation of their SOEs as a result of attempts during reform-communism to decentralize decision-making somewhat and increase the operational and financial autonomy of SOEs.<sup>60</sup> In addition, workers were and are a political force to be reckoned with. The preferences granted to management/employees in the privatization of their SOEs therefore should not surprise. As noted, *management/employee buyouts* are a predominant method of small-scale privatization in Russia, Romania and Poland. In addition, some countries have adopted schemes under which management/employees of large SOEs are encouraged to participate in the privatization process on preferential terms (also if the SOE is included in a mass privatization program or slated for disposal in a trade sale).

Although the details of management/employee incentives vary from one country to another, the incentives have the common end to encourage management/employee participation in the privatization process. Incentives are particularly important in the privatization of large SOEs, where the capital requirements effectively restrict the management/employees from amassing large stakes in their SOEs on market terms. In the circumstances, some countries in the region allow management/employees to purchase shares in their SOEs at a discount from market. Many countries also provide preferential financing, installment and similar arrangements designed to encourage management/employee participation.

The incentive schemes adopted in the region appear to favor management/employee minority participation on preferential terms to acquisition of controlling stakes in privatizing SOEs. However, in reality control seems more important to management/employees than do preferential discounts. This is aptly illustrated by the Russian privatization program, under which

<sup>60</sup> The workers often exercised the responsibility for the SOE through a collective assembly of all the workers, and through a representative workers' council between meetings of the assembly. The workers' council had many of the attributes of a board of directors in a Western sense, sometimes including the power to appoint the general manager or veto the nomination by the founding organ. Thus, in many SOEs the workers' councils had a strong position. In SOEs where the workers' councils remained weak, the SOE management often had *de facto* control. See, e.g., D. Lipton & J. Sachs, *supra* note 20, at 304–05.

management/employees have a choice. That program provides an opportunity for management/employees to choose one of three arrangements for their benefit. The first arrangement entitles employees to receive a significant chunk of non-voting preferred shares (up to 25% of the capital) free of charge, and to purchase a smaller portion of common shares (up to 10% of the capital) at a discount from par value. Under the second arrangement, employees are entitled to purchase common shares representing a majority (up to 51% of the capital), but without preference as to price. The third option, finally, contemplates that a group of employees take responsibility for restructuring their SOE within one year. If the restructuring successfully meets the established targets, the group is entitled to purchase a significant tranche of common shares (up to 30% of the capital) at par value and the group and other employees have the right to acquire a similar-size tranche of such shares (up to 20% of the capital) at a discount from par.<sup>61</sup> Some 70–80% of privatizing SOEs reportedly have opted for the second arrangement.<sup>62</sup>

Transactions with SOE management/employees may cause policy concerns as regards transparency and protection of state property. Given the problems encountered in connection with the valuation of SOEs, competitive bidding is probably the best shortcut to a market-based value and the patron saint of transparency in the privatization process. However, insider purchases are rarely subject to competitive pressures. Although many countries allow independent privatization proposals to be submitted, insiders naturally have a critically important advantage: unrestricted access to privileged information.<sup>63</sup> In addition, in the tumultuous environment of the region critical information can easily be manipulated to the detriment of potential investors. Many trans-

<sup>61</sup> See Presidential Decree No. 2284 on the "State Program for Privatization of State and Municipal Enterprises in the Russian Federation" (Dec. 24, 1993), at § 5.3 [hereinafter the "Russian Privatization Program"]. For a discussion of the optional arrangements under the State Program of 1992, virtually identical to the ones set out in Decree No. 2284, and other employee preferences in the privatization, see *D. Birenbaum, Business Ventures in Eastern Europe* § 2.02[b][7] (2d ed. 1994). See also *Not the real thing yet, The Economist*, March 12, 1994, at 42.

<sup>62</sup> See OECD, *Trends and Policies in Privatisation* 34, 37, 40 (Vol. 1 No. 3, 1994). Although nominally without preference as to price, Russia's inflationary environment renders also this option a virtual give-away with deep discounts from market values. See *Bargain debasement, The Economist*, May 8, 1993, at 73.

<sup>63</sup> The Czech privatization illustrates this point. Although SOE-initiated proposals only accounted for some 25 percent of all proposals made by mid-1993, they comprised some 80 percent of all proposals then accepted. See J. Charap & A. Zemplerova, *Management Buy-Outs in the Privatization Programme of the Czech Republic*, in OECD, *Trends and Policies in Privatisation* 142–43 (Vol. 1 No. 3, 1994).

actions with management/employees may therefore in effect amount to a partial give-away of state property.

A give-away of state property to insiders is not entirely consistent with the objectives of trade sales. In addition, such a give-away raises questions of fairness. It is clear that employees of potentially viable SOEs come out better in the end than employees of SOEs waiting to go bankrupt once the umbilical cord with the state is severed and the SOEs are thrust into the market to defend for themselves.<sup>64</sup> Similarly, employees of SOEs put up for privatization are favored relative to employees of SOEs scheduled to remain in state hands (not to mention unemployed individuals and retired employees).<sup>65</sup> The participation of SOE management/employees in the privatization could also impact negatively on the willingness of outside investors to commit considerable resources to privatized SOEs. There is justified fear among some investors that substantial management/employee ownership could jeopardize the necessary restructuring. Although management/employee share ownership should contribute to aligning the interests of the management/employees and those of other shareholders, radical restructuring measures could be difficult to push through in privatized SOEs with substantial employee ownership.<sup>66</sup>

In the circumstances, the preferential treatment of management/employees in the privatization process bears the hallmark of a *political trade-off* to make privatization work. Given the inherent conflict between the severe shortage of qualified personnel in the privatization bureaucracy and the objective of rapid privatization, it is not surprising that some privatization tasks have been delegated to the SOEs themselves. Hence, the management/employees are often charged with preparing proposals for the privatization of their SOE. The information asymmetry discussed above reinforces the significance of active management/employee cooperation in

<sup>64</sup> See, e.g. D. Lipton & J. Sachs, *supra* note 20, at 308–11 and F. Dhanji & B. Milanovic, *supra* note 20, at 16–17.

<sup>65</sup> The Russian privatization program partly addresses the fairness issue by including retired employees and registered unemployed persons dismissed from the SOE after Jan. 1, 1992 as a result of staff reductions in the category of persons entitled to purchase shares in the SOE on preferential terms. See the Russian Privatization Program, at § 5.3.

<sup>66</sup> The corporate governance implications of management buyouts are different from those of employee buyouts. In contrast to employee buyouts, management buyouts allow for relatively streamlined decision-making and present few obstacles to restructuring. See generally M. Bracklo, *supra* note 56, at 97–99. Similar concerns arise where the state plans to retain a substantial stake in privatized SOEs. There is suspicion among many investors that the state would be unable to exercise its influence on a commercial basis and that political considerations would dictate its *modus operandi*.

this process.<sup>67</sup> However, privatization inevitably deprives management/employees of privileges seized before the communist downfall and is bad news for many employees who will be thrust into unemployment. In many cases existing managers are likely not suited to lead their SOEs into a more market-based environment where the importance of political connections have surrendered to the forces of free competition. It would be naive to expect management/employees to accept voluntarily disenfranchisement and deprivation of job security without compensation. The preferences granted in some countries to management/employees in the privatization of their SOEs should therefore be viewed primarily as an attempt to induce their cooperation in the privatization process.

### *3.5 Choice of Method and Progress to Date*

Given the variety of SOEs slated for privatization, there is no one privatization method which is universally appropriate for all SOEs. Most countries in the region have therefore adopted a multi-track approach to privatization. A smorgasbord of different privatization methods coexist in most countries. As noted, small-scale privatization is normally carried out separately from large-scale privatization and often by auctions and/or management/employee buyouts. In contrast, large SOEs as a rule are privatized through mass privatization, trade sales, public offerings and management/employee participation. Two or more of these methods are sometimes used concurrently for the same SOE. For example, a division of a privatizing SOE may be spun-off to the management/employees while the remaining business is included in the country's mass privatization program and/or sold to one or more investors in a trade sale. Also, as noted, public offerings will undoubtedly gain in importance as governments dispose of residual stakes retained in privatized SOEs.

Although governments in the region have subscribed to a multi-track approach to privatization, the *focus* of the programs adopted differs from one country to another and reflects the relative weight authorities have ascribed to relevant political, economic and social factors. In the process of reconciling or prioritizing among the partly incompatible objectives and requirements of privatization, officials must strike a delicate balance among a great number of conflicting interests. This arbitration among competing interests is

<sup>67</sup> Although privatization authorities usually have the power to force privatization on recalcitrant SOEs, this reportedly has been used sparsely for political and social reasons.

a highly political act and broad-based political support is therefore needed for privatization to be successful. In the circumstances, rapid privatization to create an irreversible momentum in politically uncertain times and broad-based participation of domestic investors to shore up political support for the transformation to market economy are required. Only mass privatization and large-scale management/employee buyouts or equity investments are likely to combine both speed and broad-based domestic participation in the privatization process.<sup>68</sup> Although mass privatization would seem superior to management/employee buyouts in accommodating fairness concerns and ensuring transparency in the privatization process, the *de facto* influence of managements and/or workers' councils over the destiny of their SOEs and the political force of workers in some countries often tilt the policy choices in favor of direct management/employee participation in the privatization of their SOEs.

Mass privatization and/or management/employee buyouts constitute significant elements in most large-scale privatization programs adopted in the region. As noted, mass privatization has made a notable contribution to the progress in the Russian and Czech privatizations. Similarly, management/employee buyouts account for a sizeable portion of the privatizations to date in Russia, Poland and Romania. However, the overall progress of large-scale privatization in those countries varies dramatically from one country to another. According to some statistics, the Czech Republic has already privatized or liquidated some 60% of its large SOEs while in Romania the process of large-scale privatization has barely commenced.<sup>69</sup>

Progress has been relatively slow also in Hungary. By some accounts, only 30% roughly of the country's large SOEs had been privatized by mid-1993.<sup>70</sup> Unlike other countries in the region (except for Germany), Hungary early opted for trade sales of controlling stakes in SOEs to one or more specific (often foreign) investors or groups of investors as the pinnacle of its privatization program. In view of Hungary's precarious debt situation at the end of the 1980s, it is not surprising that one of the stated objectives of

<sup>68</sup> The statement applies to large-scale privatization only. Small-scale privatization auctions as a rule have been rapid and attracted broad-based domestic participation. Many countries in the region either have completed or are coming close to completing their small-scale privatization programs. See OECD, *Trends and Policies in Privatisation* 15, 29–30 (Vol. 1 No. 3, 1994).

<sup>69</sup> See *id.*, at 15, 40.

<sup>70</sup> See *id.* at 15, 40.

its privatization program was to bring revenues to the state.<sup>71</sup> Given the scarcity of financial resources in the country, privatization authorities courted primarily foreign investors to put up the funds. A focus on individual transactions therefore seemed the natural approach and rapid privatization was relegated to a backseat role. However, Hungary recently advanced a scheme for mass privatization in the face of criticism over the slow pace of privatization and the foreign bias at the early stage of the process. As noted, that program is different in significant respects from other mass privatization programs adopted in the region and has yet to be implemented.

The Hungarian focus on trade sales prompts the larger question of foreign participation in the privatization process. Given the relative scarcity of domestic capital, management know-how and technology, foreign investment surely will prove vital to the systemic transformation of Central and Eastern Europe. In addition to bringing much-needed resources in those areas, foreign investors are uniquely positioned to expedite the international market integration of privatized SOEs. Although foreign investment is recognized by reform-minded politicians as a necessary ingredient in the resuscitation of the region's moribund economies, significant direct foreign investor participation in the privatization process may jeopardize the broad-based political support needed for privatization to be successful. In the face of criticism from populist groups in some countries that the "family silver" is being sold off to foreign interests at bargain prices, politicians are forced to perform tightrope balancing acts weighing carefully the political, economic and social implications of foreign investor participation in the privatization process.<sup>72</sup> As noted, mass privatization and management/employee buyouts have emerged in the region as the favored political recipe.

Mass privatization and management/employee buyouts effectively curtail foreign investor involvement in the privatization process. Although in some countries foreign investors may acquire vouchers from their owners and bid them at an auction, it may be

<sup>71</sup> See, e.g., OECD, *Economic Surveys — Hungary* 107–09 (1991) and OECD, *Economic Surveys — Hungary* 73–74 (1993).

<sup>72</sup> The constraints on direct foreign investor participation in the privatization process reflect the political nature of that process. While aiming at encouraging foreign investment generally, most governments in the region seek to ensure broad participation of domestic investors in order to secure the necessary political support for the privatization process. A clear sign of this apparent conflict is that local preferences in the privatization process often coexist with substantially liberalized foreign investment regimes. Foreign investors now have access to most sectors (except defence, public order and financial institutions which either are closed for foreign investors or require special authorization) in many countries.

cumbersome and risky to amass the volume of vouchers necessary to secure control of privatizing SOEs. In the absence of some measure of control, many foreign investors are unwilling to commit the quite considerable resources required for the restructuring of SOEs post-privatization. Similar concerns are relevant where the management/employees enjoy a position enabling them to block necessary restructuring measures. In the circumstances, interested foreign investors are relegated to acquiring larger stakes principally in the secondary markets post-privatization. It is therefore critical that the proper framework necessary to permit existing owners (including management/employees) to liquidate their positions and new owners to consolidate control be developed with some urgency. Unless secondary markets for controlling stakes in privatized SOEs develop rapidly, the much-needed restructuring of the troubled industry in the region could be delayed.

#### **4. Concluding Remarks**

The liberalization of the economies in the region has brought about an enormous growth in private sector activity. Concurrently, public sector output has contracted dramatically. The relative size of the private sector therefore has grown markedly over the past couple of years, perhaps more so in Poland than in other countries in the region. It is estimated that the Polish private sector currently accounts for some 50% of GDP and 60% of employment.<sup>73</sup> Much of this development results from the autonomous expansion of the private sector and the successful privatization of small and medium-sized SOEs. As discussed, many countries in the region either have completed or are about to complete their small-scale privatization programs. The privatization of large SOEs has proved a much more delicate task and only few countries, notably the Czech Republic and Russia, have made significant headway in this area. Some form of mass privatization has usually been a prominent ingredient in the privatization programs of those countries. Other countries are increasingly emulating this pattern with a view to securing progress under their domestic privatization programs and expediting the transformation to market economy.

The concept of mass privatization could be difficult to reconcile with effective corporate governance. Governments and policy-makers fully recognize the inherent conflict between a concentrated ownership structure and broad-based domestic participation in the privatization. Spontaneously organized or governmentally

<sup>73</sup> See, e.g., *Bus. E. Eur.*, Jan. 17, 1994, at 4.

mandated investment funds, interposed between the share-owning public and privatized SOEs, have emerged in most countries as the favored recipe. However, it remains to be seen whether fund managers possess the skills necessary to guide the privatized SOEs in their portfolios through the restructuring phase and whether they have the incentive and strength to push through unpopular restructuring measures. Similarly, it remains to be seen whether fund managers and investors are prepared to take the long-term view probably required as many troubled and newly privatized SOEs in fund portfolios may yield an acceptable return only several years into the future.

In the circumstances, the development of efficient secondary markets for shares in mass-privatized SOEs should be a priority in the region. The facilitation of secondary market transactions could help consolidate ownership and control with investors willing and able to carry out the necessary restructuring. It will undoubtedly be a challenge in this context to enhance dramatically the generation and dissemination of reliable business information to the markets. Also confidence-building measures in the securities regulatory and enforcement areas will be necessary ingredients in the build-up and reformation of the local securities industry. However, these reforms may prove ineffective unless privatized SOEs are allowed to compete on an equal footing with SOEs which remain in state hands or under state control. As noted, it may be tempting politically to continue the state-support of inefficient SOEs until the private sector is able to absorb redundancies unleashed by public sector restructuring. In addition to its possibly adverse budgetary implications, the subsidy-practice could distort competition in the local markets and perhaps influence negatively the inflow of foreign capital. The real challenge to governments and policy-makers in the region will therefore be to overcome short-term political ambitions and strike a delicate balance between free and undistorted competition and social considerations.