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Holger Schmieding*

Issues in Privatisation

In 1990 the privatisation debate in the ex-socialist countries advanced considerably. By now, the fundamental importance of private property for a market economy and the pitfalls of employee-ownership schemes are rarely disputed. Instead, the need for rapid privatisation and suitable methods of achieving it have become the main topics of discussion and the major challenge for policy-making.

Given the dismal state of many present firms and the time which privatisation will inevitably consume, the growth of the private sector and hence the economic re-emergence of the post-socialist countries will have to come about to a considerable extent via the establishment of new private enterprises and the growth of existing small units (bottom-up emergence of capitalism). One of the first tasks of any privatisation ministry or agency should thus be to make sure that all *de jure* and *de facto* obstacles to the establishment and expansion of small and of new private firms are removed. Note that this includes an adequate supply of land and of shop and office space. The liberalisation of all real estate markets, naturally socially cushioned by rent subsidies for the needy, seems to be at least as important as the disbursement of, say, 500 existing firms.

There seems to be a virtual consensus that it would be nice if the entire institutional infrastructure of a market economy, including private property, existed at the time when a comprehensive programme of macroeconomic stabilisation, microeconomic deregulation, current account convertibility and external liberalisation is enacted. That this infrastructure had not been destroyed by the Nazis and the Allied victors is one of the two major reasons why West Germany's switch from a command to a market economy in June 1948 was such an immediate success, with industrial production rising by more than 50 per cent within six months according to the official statistics (the other reason being the exceptionally high productivity of investment in the repair of the existing up-to-date capital stock). Unfortunately, this infrastructure does not exist in post-socialist countries. While markets may be liberalised at the stroke of a pen, the establishment of the institutional infrastructure is inevitably time-consuming. Hence, two schools of thought about the appropriate place of the privatisation of existing firms in the transformation process can be identified:

□ Micro and macro issues should be tackled first, time-

consuming privatisation thereafter. This view manifested itself *inter alia* in Poland's courageous transition programme of 1990; it seems to correspond to the early preferences of most Western economists – who usually take a market-conformable institutional infrastructure for granted in their models.

□ Property reform should be the basis of economic reform. This was the major message of the famous Yavlinsky-Shatalin plan dumped by Gorbachev last October; the idea was stressed very early *inter alia* by Lewandowski and Szomburg in Poland. In general, this view seems to be quite prominent among the radical liberal economists in central and eastern Europe.

In a strict command economy, it hardly matters whether a manager of a state firm or a private owner has to obey the central orders. The more the strict command system gradually degenerates into a chaotic negotiation system or the more it is abolished by conscious economic reforms, the greater will be the scope for pursuing individual interests. Hence, the more important it will be whether the incentives for individual action are economically efficient or not.

To put it differently: micro-deregulation and liberalisation is needed to create markets; macro-stabilisation is to make sure that market signals are not obfuscated by inflation. If managers of state firms do – or can be made to – react to market signals in a textbook manner and to care about long-run profitability almost as if they were controlled by private owners, there would be no need for hurry in privatisation; if they do not, stabilisation and deregulation would lead to little else but a protracted slump in the absence of *ex-ante* privatisation.

So how may managers of state firms behave after stabilisation and deregulation? Some of them may be simply incompetent, i.e. unable to react rationally at all in a new environment. In this case, immediate privatisation is clearly advantageous as a means of facilitating the removal of incompetent managers. Unfortunately, the pool of talents from which new managers can be drawn may be quite limited.

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Three Strategies

Rational self-interested managers have a choice of three strategies (which are not always mutually exclusive):

☐ *Wait and see.* Their major interest may be to try to keep their present job and to act very cautiously, especially as long as they have some doubts as to whether the new policy regime will last. They will be particularly inclined to avoid painful choices, to cut production rather than costs, to pin their hopes on subsidies and to use their time to clamour for such subsidies from the state—or from banks if those banks are still unlikely to go bankrupt.

☐ *End games.* If managers are afraid that they will lose their job in the near future anyhow, they have a particularly strong incentive to use their remaining time to enrich themselves at the expense of the firm, be it via ordinary theft or via some more sophisticated variants of "spontaneous privatisations".

☐ *Reputation-building.* If managers consider it likely that they may make a future career in the management of a private firm, they may do their best to establish their credentials and hence to lead their firm as if it were privately owned already, at least within the confines in which they have to operate.

Only the third strategy implies an economically efficient behaviour. Nevertheless, some variants of "spontaneous privatisation"—disregarding the unpleasant distributional implications—may lead to the emergence of efficiently-run private firms rather than a mere plundering of state property as well. In all three cases, the managers, often discredited by their nomenclatura past and lacking political backing in the transition period, are likely to be in a particularly weak position vis-à-vis excessive demands from workers. Given the threat of inefficient behaviour, the time span in which managers have such choices at all should be kept as short as possible via rapid privatisation. Furthermore, speedy privatisation seems to be the only way to resolve a fundamental dilemma between the microeconomic and the macroeconomic requirements of the transformation process. To achieve a more efficient allocation of labour, the labour market has to be liberalised and wages have to be quite flexible to allow for the substantial wage differentiation needed to steer workers of different qualification levels into their optimal uses.

From the macroeconomic point of view however, wages have to be kept under strict control in order not to endanger the success of the stabilisation programme. In spite of the allocational distortions that were preserved or even exacerbated in this way, Poland therefore resorted to punitive taxes on excessive wage increases in 1991. The wage cost explosion in the former GDR in 1990 indicates

what may happen in free wage bargaining between unions and state firms. Once unions have to negotiate with the representatives of profit-oriented private owners operating under a hard budget constraint, the labour market policy could become more liberal. For the meantime, wage controls should be less strict in the nascent private economy than in the state sector. This might even convince some reluctant workers and managers to support the immediate privatisation of their firm in order to evade the harsh controls.

Until privatisation has been largely completed, policy-makers ought to think of ways to make the reputation-building strategy more likely, i.e. to lengthen the time-horizon of managers of state firms:

☐ To the extent that this is politically feasible, it could be made clear that qualified managers will be given a chance regardless of their past role in the nomenclatura;

☐ in exchange for a cut in their current income, managers could be promised a fixed share in the future privatisation proceeds to make them care about the capital value and hence the long-run profitability of their firm.

Although the case for early or even ex-ante privatisation is rather convincing, it may not always be feasible:

☐ The appropriate sequencing depends on the time pressure. With inflation getting out of control, Poland in late 1989 did not have much of a choice but to put the package of macro-stabilisation and micro-reforms first. Once a legitimate government is installed in the Soviet Union—or once the existing legitimate authorities of the republics can effectively pursue their own economic policies—the macroeconomic mess may be so great as to make stabilisation the first priority in the Soviet Union and/or its successor states as well.

☐ Even if the economic circumstances warrant a period of institution-building before the switch to free markets is made, as they obviously did in the CSFR in 1990, it may not be easy politically to use the time very effectively. And time is probably the scarcest commodity of all. In spite of the theoretical advantages of large-scale ex-ante privatisation, it could still be necessary to go ahead with the micro and macro reforms first—and hope that the ensuing economic crisis will put rapid privatisation much more firmly on the political agenda. A fair amount of "learning by mistakes" may be inevitable, whatever clever things theoretical economists may have said in advance.

Apart from ownership, the extent to which firms are subjected to competitive pressure is the second factor determining allocative and productive efficiency and adjustment flexibility. If firms are shielded from competition, privatisation will not result in the desired congruence of the incentives for individual action and the

common welfare. Hence, privatisation is next to useless unless it is accompanied by a hardening of the budget constraint for firms. On theoretical grounds, it can even be argued that – given the chance – self-interested private owners will be even keener on obtaining subsidies than managers of state firms whose personal income is less directly linked to the financial situation of their firm. A similar argument applies to firms enjoying a monopoly position. After privatisation and the transition to a market economy, they are likely to enhance their productive efficiency. At the same time however, they are even better posed to exploit their monopoly position than before. Hence, it appears that de-monopolisation ought to be linked to privatisation. However, this applies only to producers of non-tradable goods and services. For tradables, trade liberalisation is a swift and easy competition policy, and the only necessary one. As cars are clearly tradable, there is for instance no need to worry about the size or the market share of Skoda in Czechoslovakia, unless the Czechoslovak government intends to drastically impede imports.

The major obstacles to a swift privatisation are

- ☐ the claims of previous dispossessed owners,
- ☐ the present practice of self-management,
- ☐ the lack of capital market institutions, of suitable data and of the qualified accountants needed for orderly British-style privatisation,
- ☐ the ignorance about the future value of the firm arising from the uncertainty about both the future prospects of individual ventures and the future institutional and macroeconomic environment, and
- ☐ the lack of domestic financial assets.

Most importantly, privatisation is political dynamite. Its core is the grand scale redistribution of property rights, wealth and opportunities at a time of general economic turbulences – and a time at which the new democratic institutions may yet be untested. Such a process is necessarily corruption prone. And even if all those who handle privatisation were genuine angels, the wild fluctuations in asset values to be expected initially will give rise to popular allegations of errors, incompetence and corruption. Hence, it seems essential to foster public support for the privatisation process.

General Requirements

With regard to the claims of previous owners, economic efficiency is hardly affected by how they are settled (restitution in kind, financial compensation, vouchers for the purchase of state property). What matters instead is that the property rights uncertainty is removed immediately and reliably, with rules that should perhaps be

enshrined in the constitution to emphasize their final character. Property rights uncertainty is much more damaging than a distribution of property rights which may be somewhat questionable on moral grounds. In any case, it seems unlikely that a total consensus on the moral issues would ever be feasible. Ideally, all future legal quarrels should merely be about the financial compensations to be paid by the state to those who may have been treated unfairly, not about the fate of the real asset. As the state can be seen as an encompassing and hence comparatively efficient insurance system, the future legal risks should be borne by the state and not by private owners who – being typically risk-averse – would ask for a risk premium exceeding the expected value of future payments to claimants.

In a similar vein, it ought to be clear who controls the firms in the meantime and decides upon the privatisation process in any particular case. Preferably, this should not be enterprise councils or managers but a state agency. Rival claims by the employees could be settled by granting them preferential conditions for obtaining a certain part of a firm's ownership titles. If these initially earmarked shares are to be freely tradable in the near future, the drawbacks of employee-ownership schemes would be avoided.

To minimize the danger of abuse, corruption and insider deals and the ensuing political problems, the privatisation process ought to be as transparent as possible. Ideally, all firms – or bundles of shares in larger firms – should be sold at open auctions or in open tenders to the highest bidder, regardless of whether the bidding is done in money or vouchers. Naturally, an open auction may not always be feasible, especially in the case of many large firms. In order to ensure corporate control, the first step should be to disburse a controlling stake in a major firm to a single investor. This may frequently require a negotiated deal. Nevertheless, even in these cases, at least the details of any privatisation of state property should be made public in advance (except perhaps for the price and the name of the prospective new owner, although it may be futile to try to keep this a secret). Within a fixed period of time, say six weeks for large firms and three weeks for small firms, everybody should be entitled to make a counter-offer, with the most attractive bid being automatically successful.

To speed up the privatisation process, the right of initiative should not be constrained to the state agency (or preferably: agencies) handling the privatisation. Instead, every prospective buyer should be able to declare his interest in a firm. This should automatically trigger the privatisation procedure described above within a fixed time span.

General requirements of this kind leave ample scope for the choice of the appropriate privatisation method. The

most interesting – and most hotly debated – issue is whether state property should be sold for money or be given away for (almost) free. Appropriate methods should:

- ☐ cope with the institutional shortcomings,
- ☐ overcome the lack of domestic financial assets,
- ☐ foster political support, and
- ☐ facilitate the immediate participation of foreign capital.

The logic of give-away schemes is that they serve at least the first three purposes: most notably, they are seen as introducing an element of fairness and equity and of giving domestic citizens without substantial savings of their own the opportunity to become property owners.

Note, however, that the case for give-away schemes is less clear cut than may appear at first glance. Is the oft-mentioned lack of domestic financial assets really an impediment to privatisation that needs to be cured by creating a specific investment-money (vouchers)? This holds true only if privatisation were to be completed extremely rapidly, say in less than two or three years. Consider the financial consequences of sales instead of give-aways: at given levels of state expenditure and budget deficits (which should be kept to a minimum anyhow in order to support the macro-stabilisation), the population would reap the financial benefits of privatisation via correspondingly lower direct and indirect taxes. This would imply a substantial increase in net incomes which could be used to purchase state property. In this case, the famous lack of liquidity to buy state property takes care of itself with a slight delay, even without vouchers.

The oft-asked questions whether domestic citizens can afford to buy ownership titles in firms and how their net wealth is affected are not really matters of sales versus give-away schemes. Sales-cum-tax-cuts and give-aways are mainly different ways of distributing the same amount of wealth. Even if in the case of sales the prices are depressed by a shortage of domestic financial assets, this apparent advantage for the new proprietors at the expense of the treasury would be offset on the macro-level by a reduced scope for tax cuts. Whether the net wealth of the citizens as a whole is affected, depends on two issues:

- ☐ If the state gets privatisation revenues and wastes them, the net wealth effect is clearly negative. This hazard would constitute a proper argument for give-aways.
- ☐ If foreign capital is allowed to participate in the privatisation process from the very beginning, this will enhance the profitability of firms and thus their values. Regardless of the way in which the financial advantages will be distributed to the population, this amounts to a net addition to the wealth of the domestic citizens.

Hence, the real political argument for give-away schemes is not that they increase the financial or overall wealth of citizens but that they make the financial gains from privatisation much more visible – and more directly identifiable with privatisation – than in the case of property sales cum tax reductions.

Distribution of Vouchers

While the distribution of vouchers for the purchase of state property serves three of the four purposes listed above, it does not facilitate the inclusion of foreign capital. Furthermore, this approach has considerable drawbacks:

- ☐ An inexperienced populace has to make choices between firms (or mutual funds) under conditions of extreme uncertainty. Advice will be sought after without established ways of discriminating between good, bad and plainly fraudulent advice. The wild and ultimately unpredictable changes in asset values to be expected in the first phases of transition are likely to cause considerable political unrest in this context. Some citizens who have invested in firms that turn out to be unviable will end up with nothing, while some of their lucky neighbours will get rich very quickly. Many citizens may feel compelled to sell their vouchers as soon as possible, temporarily depressing the price of the vouchers and hence reducing the financial gains of these citizens.
- ☐ If vouchers are the major means of privatising a big firm, the initial result can easily be an excessive spread of ownership. This would impede the effective control of firms by private owners.
- ☐ So far, this article has assumed that the purposes of privatisation are to improve productive and allocative efficiency, to enhance the responsiveness to market signals in order to mitigate the adjustment crisis and, last but not least, to make the entire regime switch more credible and less reversible. These purposes are compatible with each other. A wide dispersion of ownership may be seen as a further desirable feature of its own, worth some losses in efficiency (“people’s capitalism”). So could there be a conflict of purposes in this respect? In the view of the author, this is not the case because the very idea of people’s capitalism is largely a delusion. Unless one makes the rather implausible assumption that the choice of a privatisation method can lastingly change the portfolio preferences of the population, the ownership titles will ultimately be concentrated in the hands of those citizens and institutions who want to own real assets and perhaps even exercise corporate control. Trying to impose a wide dispersion of ownership by issuing vouchers for the purchase of state property will turn out to be a largely futile exercise; it is

bound to give rise to substantial information and transaction costs in a lengthy period of asset reshuffling on underdeveloped capital markets. Note that this does not apply to the kinds of property people tend to know a lot about and which they tend to keep once they have acquired them, most notably flats and pieces of land. Vouchers or other incentives for buying such property may be a comparatively successful way of broadening real asset ownership.

Mutual funds may help to avoid some of the pitfalls of voucher schemes. However, if this argument is meant to apply to mutual funds that emerge spontaneously in the market, there would still be great temptations for fraud given the inexperience of the public; if it is meant to apply to mutual funds established at the initiative of the state and under close state supervision, the transfer of ownership titles from a privatisation ministry to such a mutual fund may be considered a mere change of labels rather than privatisation. In the latter case, the establishment of such funds would at best constitute a step on the way towards eventual privatisation proper; such mutual funds should be compelled by law to sell their assets within a fixed period of time.

A distribution of sales revenues offers roughly the same advantages as the voucher scheme while avoiding its major drawbacks. If state property is sold and a considerable percentage of the privatisation proceeds is distributed directly among the population on a regular basis, say every three months, and on equal terms, this could help to foster political support for the privatisation process. Citizens wanting to buy ownership titles could use the revenues accruing to them for this purpose, the financial assets of the population would be replenished regularly so that the privatisation would not be hampered by a persistent lack of savings. Ownership titles would be acquired by those who want to hold them and perhaps even exercise corporate control; the hazard of an excessive spread of ownership would be minimised. Most importantly, the distribution of proceeds could help to weaken opposition against the participation of foreign capital. The more foreigners are allowed to bid for ownership titles in state firms, the higher will be the prices – and hence the privatisation proceeds to be distributed to the citizens. The citizens would thus experience a direct and positive link between foreign capital and their own material well-being. Some voucher schemes, on the other hand, are explicitly designed to keep foreign capital out of the first stages of the privatisation process.

Foreigners are not the only group of prospective owners which many people would like to exclude. If the ex-socialist countries really want to keep former black-marketeers and discredited nomenclatura members out of the

privatisation process, the wealth of these people would have to be confiscated outright. It would be rather useless to restrict their portfolio choices. If they have their wealth and want to become shareholders or owners of small firms or shops, they will find ways to do so, either legally once trading restrictions for the original purchasers of this property are lifted or illegally via front men. Trying to impose some devices to prevent this would be almost fruitless – and give rise to a damaging property rights uncertainty.

Limited Use of Vouchers

It seems quite likely that the intellectually fascinating idea of vouchers will be implemented to some extent. Vouchers may be comparatively useful for a certain percentage of the shares of some major firms, especially the well-established and export-oriented ones that have proven their worth on the world market. In these cases, there would be comparatively little value uncertainty. Once an investor for a dominant stake in a major firm has been found, it makes no major difference whether the remaining shares are privatised under a voucher scheme or by any other method.

Furthermore, the arguments against the widespread use of vouchers apply only to the privatisation of large firms, not necessarily to that of land, residential buildings and flats. Vouchers could be particularly appropriate for small-scale privatisation: since people, say the extended family, could easily pool their vouchers to acquire a small business or shop, there would be no excessive dispersion of ownership of individual ventures; since people tend to have a comparatively good idea of what the piece of land, the flat or the shop next door might be worth, there would be less confusion and value uncertainty than in the case of using vouchers for large-scale privatisation. Hence, in comparison to the option of sales cum tax reductions, vouchers may popularize and speed up the crucial process of small-scale privatisation – which will favourably transform the structure of society as well as that of the economy.

All in all, the proponents of vouchers need to be explicit about the purpose which vouchers are intended to serve. If they are meant to popularize the privatisation process, they should be used for the best state firms and for the comparatively attractive small-scale privatisation in order to minimise the danger of political discontent. If vouchers are to be employed for cases in which other privatisation methods are supposed to fail, inter alia for less attractive firms for which no dominant investor can be found, vouchers may to some extent be a helpful technical device. Unfortunately, they may turn out to be very unpopular once a sizable number of firms in which people have acquired shares via vouchers goes bankrupt.