THE USV ANNALS OF ECONOMICS AND PUBLIC ADMINISTRATION | VOLUME 12, ISSUE 2(16), 2012

THE PRIVATIZATION OF STATE OWNED ENTERPRISES IN THE EARLY TRANSITION: NECESSITY, METHODS AND MECHANISMS

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Abstract:

Privatization assumes major objectives, such as to improve economic efficiency, competitiveness and strengthening private sector across the economy, considering that the return on capital invested in the public sector is about one third compared to that invested in the private sector. Efforts to support and modernize the private sector will increase the overall efficiency, will free up resources by reducing the financial burden of state aids directed to companies with losses, will allocate these funds for essential social objectives such as health and education. Privatization has the important task of eliminating political control on enterprises. In this paper we show that understanding the process of privatization of state owned enterprises requires in the beginning to clarify three key elements: the institutions involved, the preparation for privatization of state owned enterprises and restitution.

Key words: arguments for privatization, methods of privatization, institutions, post-privatization, shareholders, Central and Eastern Europe

JEL classification: P26, P31

THE NECESSITY OF STATE OWNED ENTERPRISES' PRIVATIZATION, OR BETWEEN MARKET FAILURE AND GOVERNMENT FAILURE

The major objective of privatization is to improve economic efficiency, competitiveness and sustainability of the private sector from the entire economy. According to researchers, enterprises return on capital invested in the public sector is about one third, compared with the private sector (Piesse, 2001).

Thus, raising capital to support and modernize the private sector will increase overall economic efficiency, will free up resources by reducing the financial burden initially directed towards companies with financial deficit in the public sector, redirecting these funds to socially beneficial projects such as health and education. Privatization will make a further important task, of removing enterprises from political control

What arguments support privatization as a necessity?

The interaction between governments and markets should not consider that the two forces can be interchangeable, and if competition in the market proves to be the most efficient way to organize production and distribution of goods and services, the state must provide an appropriate institutional framework and should intervene if the markets prove inadequate or limited. It is important to examine the causes and consequences of market failure. The best way to understand the market failure is to start by understanding market success. Adam Smith argued that each individual pursues his own interests, and in a market economy, these would also serve the common well-being. Therefore, according to neoliberal theory, if markets are complete so that no transactions are lost, and if there are enough buyers and sellers so that none can influence prices, the result of market functioning will be efficient. Therefore resources will be fully used, properly allocated to efficient companies and an optimal combination of goods and services produced will be achieved, in other words a combination that will maximize consumer welfare, will remunerate adequately holders of capital and resources through the optimal achievement of revenues In addition, efficient markets also depend on the assumption that information is perfect, that the provision of information itself is subject to the market. Control (monopoly) on information leads to market failure, as much as a monopoly on resources. Therefore it becomes clear that the development of perfectly competitive markets is difficult, and the understanding of the nature and extent of imperfections is very important. Government intervention can be justified only if resources are not fully engaged or if the distribution of the market outcome is unacceptable.

a. Market failure

Markets may fail because of two main reasons. The first refers to a situation where there are structures that undermine the perfectly competitive market, as there are too few market participants. The second reason concerns the situation when markets do not exist, may be incomplete or fragmented. This allows transactions generate no multiplication effects or negative externalities occur, i.e. where production or consumption activities of an economic group reduce the activity of another group, and the effect is not resolved by the price system. Moreover, this type of market failure tends to worsen at lower levels of development. In addition, although the existence of monopoly and negative externalities are separate concepts, they tend to interact and cause market failure and thus an erroneous allocation of resources.

b. Government failure

Market failure is a necessary but not sufficient condition for government intervention, "because it is assumed that existing imperfect institutional arrangements can be compared with an ideal norm"(Piesse, 2001).

In other words it is possible that government failure can lead to a result that is less desirable than market failure. The results of government intervention include lack of incentives, corruption, discrimination and seeking rents. In addition, there is no reason why the state would act better than the private sector unless the cause of market failure is poor information and the government has access to quality information.

c. Acceptance of government intervention

Government intervention can be supported when the aim is to maximize social welfare and eliminate the negative effects of market failure. In developing countries setting the cases of lack of functioning is obviously necessary, because in these economies market failure remains pervasive If markets are incomplete or non-existent, the public sector's role is supposed to be higher than in economies with well-developed markets, applying the general principle - the smaller the level of market development, the greater the frequency of market failure, and thus greater the need for state intervention.

d. Reactions and arguments against state intervention in economy

On the other hand, it is argued that the government should refrain from interfering with economy, according to the following principles (Piesse, 2001):

- ideological principles: free market capitalism is a guarantor of individual freedoms and government intervention, in any form, threatens this structure. Similarly, it is considered wrong to control resources entrusted to government officials, regardless of the extent of social objectives pursued;
- logical, positive principles: these assume that personal incentives are always the best motivation and proving market efficiency leads to anti-statist. The same principle of seeking one's self-interest will always explain why government's waste gains resulting from the division of labour and personal initiative, because the funds will be directed not for economic efficiency, but where their interests are best served (power, continuity, etc.).Thus, *rent-seeking* behaviour is usually the rule and the state is an agent extremely difficult to monitor and control and there is no effective means of determining the state to achieve any particular goal.

Among other arguments against government intervention one might mention the constant increase of personnel in public institutions without any positive effect on the economic, social, and organizational plan, determining burdensome budgets that reduce the affected part of projects, the lack of real incentives. In many countries, public sector is disproportionately large, and government policies, instead of contributing to the development of market institutions, seem rather antagonistic and private activity is seen, in most cases, as a source of income, taxes, a pretext for intervention in economy, etc. (Piesse, 2001).

Structural adjustment loans and conditioned support programs provided by global institutions (e.g. World Bank) led to improved public-private relationship in the economy and imposed more efficient government behavior, but in most cases they are rather the result of coercion measures than of voluntary change of ideologies or of abusive practices.

PRIVATIZATION METHODS AND MECHANISMS

The privatization and restructuring of enterprises in Central and Eastern European countries, the stimulation of private initiative, through liberalization and ceasing bans, led to a rapid, spontaneous development of numerous activities, first in the field of commerce and services and then in industry, where fix capital investment was reduced and the implication and enthusiasm of the human capital was essential. Gradually, the small business sector defined a certain parallel economy, with characteristics borrowed both from the free market and from the informal commercial mentalities of the previous period (Communism). Later, authorities, aware of the opportunities associated with this sector, started to support the entrepreneurship through the so-called small privatization laws particularly through renting, leasing or sale of assets or units of production to small firms, somewhat limiting the access of large companies or foreign capital to this type of privatization. In contrast, the vast privatization of large state enterprises began and developed slowly in most countries: the establishment of legal and organizational framework, of responsible institutions, making lists of enterprises to be privatized and not, finding investors, monitoring each step, etc. Even if each of these steps was measured in months, even years, it is considered that this was not the biggest problem in the process of privatization of state firms.The real problems were associated with the ways in which these companies were sold or the further commitments adopted by the state or imposed on new owners, the huge debts accumulated by these companies, inadequate or obsolete facilities, unprepared management and so on, which shows that transition from state ownership to private property was not similar to privatization. Property rights issues, implementation of corporate governance, or failed restructuring prevented the creation of a "standard", functional market economy. Privatization methods have taken a multitude of forms, but most authors consider that there are three main forms of privatization: the sale to the national capital, sale to foreign investors and mass privatization schemes, plus restitution of the property abusively confiscated during the communist period (Lavigne, 1999). Each approach has specific components and application versions, and often they were combined over more than a decade. The privatization of state enterprises requires clarification, in advance, of some three key elements: the institutions involved, the preparation for privatization of state enterprises and the issue of restitution (Lavigne, 1999):

- Institutions. All countries involved in the privatization process appointed the government (by ministries) or some agency to handle this process. From extremely powerful institutions (Treuhandstalt in Germany), the complexity, extension of the process and political interventions often led to the appearance of new, "specialized" agencies, which in most cases did not make privatization more efficient. Regardless of the degree of involvement, the supervision of processes was carried out by governments, and in some cases the political balance determined the greater involvement in supervision of legislative institutions, as it was the case in Romania.
- Preparation for privatization. In most cases, state enterprises were initially transformed into joint stock companies, a process called marketization, commercialization,

corporatization or incorporation and the state, as single shareholder, entrusted its agencies the task of reducing, through various methods, the proportion held in these entities. Sometimes these agencies had the task of ex ante restructuring the sale process or, in the case of failed privatizations, resumed the process in other forms, up to its completion.

- Restitution of property. Its inclusion in the category of pre-privatization problems is caused by several reasons:
    a. Some researchers prefer not to consider it a privatization method but rather a political and ethical decision, because most of Central and Eastern European countries aimed not only at economic reform, but also at the correction (if possible) of the previous political regime abuse.
    b. Although it seemed that restitution should take place before the actual privatization (as was the case of Czechoslovakia and the Czech Republic and Slovakia in different forms, Germany), there were states that started this process much later (Romania, Russia) generating more confusion;
    c. Regardless of reasons, way of achievement (in kind or different forms of compensation) or timing, restitution, strictly regarded from the economic and organizational perspective generated huge problems, making it extremely difficult to implement.

Thus, among the most pressing problems we mention identification of former owners (their great majority being dead or having immigrated), of heirs, the identification of claimed assets (most of them having disappeared during successive modernization processes), the extension of the right of restitution of assets or economic entities towards other goods with social destination, etc. If restitution was not possible, compensation raised other problems such as that of correctly evaluating current assets, of comparing the possession or the land possessed at the moment of nationalization or confiscation, complications related to limiting the access of foreign citizens to ownership over land.

In many cases, restitution did not expect solutions from the privatization process, but chose the path of justice,

In all cases, irrespective of the solution chosen, restitution proved to be an extremely politicized issue, has alienated large groups of people – especially in rural areas, and hindered the process of the great and the small privatization. Even in its “market” form – of compensation by certificates, up to the creation of a functional capital market, they have not done much material rewards to owners, and in the case of restitution, the resumption of the productive activity and the turning of the respective business into an efficient one by former owners or their heirs was unlikely. The easiest way was that of selling the assets obtained by the owners of financial and human capital.

Table 1 summarizes the main elements of privatization, institutions, methods, techniques, indicating, where possible, the country.

Table no. 1. Institutions and methods of privatization in Central and Eastern European countries

Institutions of privatization, objectives and responsibilities		
Government	**State agencies**	**Specialized agencies, funds, etc.**
Ministries of privatization (în CZ, SK, PL, Baltic States, H) or ministries of economic reform (Rom)	State Property Agency (H), National Privatization Agency (Rom), State Committee for the Management of State Property (Ru)	Company for the Management of State Assets (H - fusion with the Agency for State Property), State (National) Property Fund (Rom, BG, CZ, SK, Ucr., Ru), State Treasury – PL
Application of general policies of privatization under government	Supporting ministries of privatization, protecting and	State-owned asset management, before or after privatization (in case

control, the selection of enterprises for privatization, examining privatization projects submitted by enterprises, participation in setting the rules and methods of privatization	representing state interests during the process of privatization or of some minority portfolios, promoting privatization programs, assistance to foreign investors, evaluating proposals .	of failure or non-inclusion in the privatization process), restructuring state-owned enterprises
The small privatization (small business, workshops, services units, commerce, constructions, housing, land funds, etc.)		
Return to initial owners: - In kind or equivalent assets (CZ, SK, BG), or land (Rom, Est.) - Compensations in cash, when other options were not possible (CZ, SK, B, Lit., Let) - Privatization certificates (BG, H SLO)	Alienation of state-held assets: - Closure, liquidation of enterprises - Sale on parts and relocation of physical assets (PL) - Sale at auction (in most countries) - Leasing - MEBO (H, PL, Rom, Ru) sometimes supported by programs of mass privatization - certificates - Free distribution (for land and housing –Rom, BG)	Sources of financing the acquisition: - Local capital - Foreign capital (often under certain formal restrictions)
The large privatization (privatization of large enterprises in industry, services, banks, etc.)		
Methods not generating revenues from the state: - Free distribution towards the population (mass privatization) Predominant in (CZ, SK, Lit., Rom, SLO, Ru)and being completed by other methods in BG, Let, PL	Methods based on stimulating the implication of local capital - ”Spontaneous” privatization - Sale by case, directly or on the capital market, started in H. And continued in most countries	Methods based on the flux of foreign capital: - Direct sale, with the transfer of the majority share capital. Required in all conuntries, widely applied in H.

Abbrevations: BG – Bulgaria, CZ – Czech Republic, E – Estonia, H – Hungary, Let – Letonia, Lit – Latvia, PL – Poland, Rom – Romania, SK – Slovakia, SLO – Slovenia, Ru – Russia, Ucr – Ukraine
Source: Lavigne, Marie (1999) *The Economics of Transition. From Socialist Economy to Market Economy*, Second edition, Palgrave

Returning to actual methods, we shall briefly review them below:

1. Selling state enterprises to foreign capital

Most authorities had high expectations for the entry of foreign capital in these countries, both for the success of privatization, establishment of new firms, but also to increase overall competitiveness, the introduction of corporate practices and more. Most of these economies had experienced, during the relaxation of the 60s-70s, foreign capital inflows (foreign trade, financial institutions and production units) but the facilities granted after 1990 were more significant and sometimes put in the shadow of the facilities granted to domestic capital and to the population (Lavigne, 1999). The relationship with foreign capital was ambiguous, facilities were often accompanied by restrictions (e.g. – the situation of land) and economic reasons had to make certain concessions to nationalist trends or concerns that the benefits of obtaining cash from privatization might be overshadowed by selective behaviour, the so-called „cherry picking”, namely that that foreign capital would be in the possession of the best assets and state firms with problems would be left for local investors or would not be purchased by anyone, remaining a responsibility of the state. To all these the real fears of authorities added, namely that the entry of large multinational companies, in some cases with turnover comparable to the GDP of the respective countries, will put governments in a position of inferiority. Although the results of privatization of large enterprises with foreign investment have been positive in many cases, more than a decade after this type of privatization, initial findings showed that entry of foreign capital is certainly not the preferred, unique solution of the privatization process. Most states have failed to privatize large parts of economic sectors and in many cases the foreign capital share was more than 60-70% (much higher than the proportion of foreign capital in the countries of origin). However, there are still undeniable advantages: accelerated privatization, the contribution of new technologies and markets, considerable financial flows, especially during critical periods experienced by host countries, etc.

2. Privatization through sales to domestic capital

In the vast majority of cases, methods and steps are similar to those of selling to foreign investors, regardless of the particular field or investment size.

One of the first difficulties was the shortage of domestic capital and its reluctance to participate to the privatization of large state enterprises, often restructured companies with huge debts and political control, so little availability was consumed in small privatization. A second difficulty was the long period of achievement. While the authorities have tried a variety of methods, prior restructuring, lists of companies, pilot privatization, etc., each transaction was a long process and experiences were inconclusive so as to replicate them during following privatization processes. Even Poland and Hungary, countries most advanced institutionally and with significant opportunities to attract capital, managed to sell only part of the proposed portfolio. Gradually, this type of privatization has given way to arguments about the method of (free) distribution of property certificates. However, privatization of state enterprises by using internal resources identified several problems that marked degree and efficiency of domestic capital involvement in the economy, whether we speak of small capitalists, interested to develop exogenously, through the acquisition of available assets, or about the large mass of citizens, encouraged to participate in the purchase of shares in listed companies:

- the reduced percentage (and continuously decreasing during the 90s in all Central and Eastern European states) of savings and of the investment rate in GDP;
- inexistent or less functional mechanisms to mobilize these availabilities, namely private investment funds, flexible financial instruments, not-privatized bank system and with little interest in co-financing the projects of local investors to buy state assets;
- a low power, volatile capital market, dominated by public offer procedures, reduced investment experience, focusing more on speculation than on long-term investment.

Finally the (free) transfer of state enterprises shares to citizens involved two versions:

- Distribution of certificates, vouchers or coupons to be converted into shares in companies prepared for this type of privatization;
- Distribution of shares to investment funds or holding owning shares in privatized companies

Not infrequently there were combinations of these variants, by which citizens could require funds to manage the received coupons

As a conclusion to privatization by internal forces, we can say that, irrespective of the preferred method, all countries have tried mass privatization, combined with other forms of removal of state ownership of enterprises, for several reasons:

- the rapid pace of the method (reported in percentages obtained and the number of "shareholders" resulted);
- being politically attractive, it ensured for a good while a number of voters and answered, at least apparently, a series of social demands;
- it could claim itself, formally or actually, as a way that opened the irreversible road to capitalism and avoided the attributes of centralism, specific to the Communist period.

3. „Spontaneous" privatization (or privatization through *insiders*)

For many researchers "Spontaneous privatization is not a specific privatization method, but rather a means whereby insiders (important persons in the respective company) managed to acquire the former state property" (Lavigne, 1999)

Who are / were these insiders? First the category of state companies managers, which is quite heterogeneous, as they came from the technical, administrative or even political structures of the old regime, to whom other persons within the firm were added, such as members of the former

structures of collective leadership established by the Communist authorities, trade union representatives, the latter having the advantage that, in addition to access to information, they could manipulate the numbers of workers in their own interest.
The process began immediately after the first political and economic liberalization measures; managers made use of new legal provisions to split the and transform its effective parts (actives, the skilled workers) in limited liability companies, in which they held, directly or indirectly, the majority of social parts. After a period in which the spontaneous privatization began to spread, there have been attempts, more or less timid or effective, to stop it (Poland, Czechoslovakia, etc.). In these conditions, the process did not cease, but assumed new forms: In some countries (Poland) it adopted the way of legal liquidation, that is of restructuration and turning viable some parts of the less efficient companies and sales to employees and managers, in fact a masked spontaneous privatization, or at least a decisive step in that direction:

- although this type of "spontaneous" privatization should not be confused with privatization initiated by the enterprises themselves and proposing the approval of authorities responsible for privatization, it is hard to believe that these proposals were not based on important information held by *insiders*;
- finally, certain forms of mass privatization (ex. Russia) had in view even important percentages allocated to employees and the management (cumulated over 51%), namely a legal form by which privatization in favor of insiders could continue

In retrospect, most researchers, practitioners and decision makers of that period agree that it was difficult to create a unitary image on that form of privatization, or to either condemn or support it unconditionally. However, several conclusions can be drawn:

- after a period in which this form of privatization took place more or less openly, the great majority of Western specialists, of international institutions involved in the financing and restructuring of post-socialist economies, but also Eastern European governments did not accept it;
  Certain Eastern-European researchers found that mass privatization was "socialized" spontaneous privatization (of course, without the efficiency and the benefits of insiders, placing the sign of equality between the two forms, as a result of combining the interests of politicians and managers (Mihalyi, P.,1992-1993);
- for a good while, managers of state companies, with all their weaknesses and little preparation for a market economy, were the only internal resource available to administrate and make profitable the existing enterprises. Indeed, they acted for the maximization of their own interests – but does capitalism say anything else? – and sometimes they identified these interests with ownership over the company they were employed for and sometimes managed to make it profitable, and other times failed. According to Lavigne, the alternative to these managers within the firm would have been that of political appointees (state was still the owner), certainly less experienced (from the technical and the commercial point of view) and without any guarantee that they wouldn't have acted in their self-interest (Lavigne, 1999);
- certain researchers (Aghion, Carlin, Blanchard) show that these managers and this method created little incentive to achieve a profound restructuration of the firm and that they were less efficient in comparison with managers brought by the shareholders who purchased the privatized state firms", that the *outsiders*-type property would be the necessary solution for the profound restructuring required by privatized firms (Blanchard, O., 1997; Aghion and Blanchard, 1993 and Carlin, Wendy, Van Reenen and Wolfe, 1997).
- however, the number of external managers, even the ones brought from Western countries, willing to take on recently privatized state firms, was reduced, and the effective transfer of management from the new owners (until recently managers of

those companies) towards the new, “external” managers, was, conceptually, extremely difficult.

Table no. 2. Methods of privatization and the main beneficiaries (shareholders)

Way of transferring existing assets	**Existing managers and employees**	**Population (in general)**	**Initial owners**	**Private foreign or local companies**
Sale	MEBO (Management-Employee Buy-Out)	Rating on the stock exchange	Untendered Sale	Mixed companies (joint venture), direct foreign investment
Distribution	Spontaneous privatization	Privatization through certificates	Restitution	-

Source: Piesse, Jenifer (2001) Privatisation and the Role of Public and Private Institutions in Restructuring Programmes, available at: http://www.sed.manchester.ac.uk/research/iarc/ediais/pdf/Privatisation.pdf, accessed on 15.01.2012

CONCLUSION

As for the necessity of privatization and its benefices in improving economic efficiency, in terms of methods, experts indicate that, basically, there are three methods: selling to foreign capital, privatization through sales to domestic capital, and spontaneous privatization (or to insiders). Nevertheless, there are the elements that give a more complex process (campaigns of mass privatization, restitution, small privatization and large privatization etc., which are often combined). We have analyzed, therefore, impact and the extent of each method, given the difficulties and stages of the process, and identify which method had the best results in given context and situation. Privatization as a process had ended, but we cannot be indifferent to the outcome of this process, if its long term effects are those expected or is just a huge social and economic experiment that failed. It is important to know, for a future research, whether privatization was followed by a real corporate governance, if this governance proved to be an enhancer or a constraint factor for business efficiency. The reduction state property and decreasing of their influence in the behaviour and performance of Romanian economy could be considered a positive result of the privatization process?

The privatization of industrial enterprises was, in the first instance, driven by "popular" motives, and less by economic reasons and, finally, privatization process has focused on selling to important investors (foreign or domestic), aiming to increase budget revenues (best possible price) and thus to achieve efficiency targets. As a result, a dispersed ownership structure was a rare phenomenon in the strategic industries, by keeping away the minority shareholders investments. This fact generated reduced capital market liquidity; thus, these strategic companies become dependent on mother companies allocations, on state funds, and rarely on the capital market. Privatization has generated a complex ownership structure, and the domination of large global players in heavy industry (in terms of capital and number of large units) and a huge number of SMEs in the rest of the industry, economically too weak to have a say in the industry or performance orientation. These quantitative dimensions must quickly shift into qualitative advantages – in terms of performance, modernization or continuity perspective. Concerning the role of the government after privatization, the state quickly withdrew from the position of owner and administrator, and gradually became more a discreet but efficient partner for large industrial groups, rather than an active minority shareholder or a defender of economic and social interests.

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