PRIVATIZATION AND EFFICIENT CORPORATE GOVERNANCE IN POST-TRANSITION ECONOMIES

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ABSTRACT

The key lessons of mass privatization implemented in Central and Eastern Europe are analyzed and presented in this paper. What are the necessary regulatory, institutional and social ingredients which provide incentive for successful restructuring of the firms in transition and what are the essential impediments which may burden the efforts of restructuring? The discussion will be presented on the basis of comparative institutional basis and it will try to provide some of the answers of how to provide more stimulating institutional environment for the future economic development in the context of Europeanization and globalization.

Keywords: privatization, improvements of corporate governance, regulatory legal framework, transition and post-transition economies

INTRODUCTION

In my contribution I would like to discuss the key lessons of mass privatization implemented in the Central and Eastern European countries in the past two decades. What are the necessary regulatory, institutional and social ingredients which provide incentive for successful restructuring of the firms in transition and what are the essential impediments which may burden the efforts of restructuring? The discussion will be presented on the basis of comparative institutional basis and it will try to provide some of the answers of how to provide more stimulating institutional environment for the future economic development in the context of Europeanization and globalization.

At the core of the transition process was the idea of mass privatization. This was a unique historical process which created certain unique historical opportunities. Free distribution of vouchers to the citizens presented a very distinctive innovation during the transition period. As it turned out, the process was so poorly regulated as to allow massive frauds and misappropriation of former state-owned assets. It was poorly regulated in the sense of insufficient rules and standard of valuations of the firms, in the sense of transparency for

the potential investors, and in many other ways. It was also poorly designed in that the voucher-privatization schemes did not create sufficient incentives for the new owners – regardless of the type of new owners, such as inside or outside owners, institutional or individual – in many of the privatized firms to bring into the firms new ideas, capital, know-how and overall support for active restructuring. On the contrary, as happened in many instances, new institutions in the form of privatization investment funds as a key instrument of privatization, in this key period of transition contributed very little expertise, support and sufficient monitoring to ensure high quality restructuring of the firms.

To provide an overview of the period of transition and integration of the Central and Eastern European countries, certain important insights should be put forward. First, there was a confusion of goals and instruments, especially in the early stages of transition. In the early stages of transition, there was a belief in the automatic positive outcome of certain reforms, for example that rapid and mass privatization would automatically lead to higher levels of productivity and efficiency of newly privatized firms. In the early stage of transition many of the privatized firms did not perform significantly better than those firms that were yet to be privatized. Second, in the absence of a coherent regulatory framework, mass privatization resembled more a struggle for redistribution of economic and political power than a long-term strategic goal of enhancing the productivity and efficiency of businesses and economies. Third, mass privatization is not a goal in itself, it is a means toward broader goals of economic development. Of the required institutions one need only to point to an efficient judiciary to protect new shareholders, large and particularly small, from various forms of asset stripping by various levels of old and new managers. In addition, various classes of creditors and investors, suppliers and consumers must be sufficiently protected to engage in a long-term productive relationship with such newly privatized firms. Complex rules of securing fair competition in the emerging market economy, allowing fair competition between old, predominantly state-owned enterprises and new, privately established firms must be in place prior to any large-scale attempt at privatization. Fourth, the role of the government does matter in all stages of transition and institutional transformation. Not in a traditional interventionist manner, but as a strategic partner to entrepreneurship, innovation and growth. Fifth, the initial allocation of entitlements and incentives does matter. Wrong incentives can lead to rent-seeking and asset stripping, instead of economic restructuring and long-term productive investments.

In which circumstances a much more nuanced, more imaginative and transparent approach toward comprehensive reforms can yield better overall results depends crucially on the comprehensive institutional framework. In the absence of organized civil society, pro-growth and development oriented political parties, in the absence of a strong, independent and initiative from the middle class, a state alliance between rent-seeking and the well entrenched interests of the newly privatized segments of society can emerge. Such an alliance can in return resist and suffocate initiatives from the weak civil society, groups of workers and the tiny middle class, it can resist and shield from the international pressures. It can present a major obstacle to more dynamic and innovative development under any institutional setting, even after formal integration into the EU. Concentration and consolidation of the property rights in the hands of a small number of insiders, usually politically well connected, as an outcome of transition can present a major impediment to overall progress. On the other hand, there were many privatization surprises, such as a relatively successful performance of employee-owned enterprises and those that remained temporarily partially owned by the state (Uvalic *et al*., 1997). Alternatively, open, inclusive, fragmented entitlements can broaden and deepen economic and entrepreneurial opportunities for many new potential entrants to the market. After two decades of transition and integration it is possible to say that an alternative institutional framework, hospitable to initiatives and able to support them, can lead to a more dynamic, innovative and inclusive society.

Even a recent study on the effects of privatization in transition economies confirms that the privatization itself does not guarantee improved performance, at least in the short and medium run (Estrin *et al*., 2009). It requires a more stimulating institutional framework, more pluralistic view of the property rights and entitlements, broader access to productive and financial means as well as improved diffusion of knowledge, technologies and expertise. Having said that it is useful to have in mind an insight on mass privatization by John Nellis who has concluded that privatization of the firms in commercial, industrial, manufacturing and service areas has been most successfully applied when firms operating in competitive markets (Nellis 2006, 23). In his studies on the privatization processes in transition economies he has also pointed to the risk of establishing insiders and their domination and to the following paradox; namely that the countries with a well-organized and accountable bureaucracy are capable of successfully running the state-owned enterprises, whereas in the countries with inefficient and corrupt bureaucracies, it is unrealistic to expect that privatization will solve all the economic problems (Nellis 1999, 22). In other words, in

societies with transparent and accountable public sector the relation between the public and private, between the government and the firms can represent a virtuous circle, in which privatization is only one of the tools for overall development; whereas in societies with little public transparency and accountability the relation between public and private represents a vicious circle, dominated by privileged insiders and rent-seekers.

Central European path of transition and EU integration

An interesting partial exception to the general pattern of widespread recession is presented by Poland. At this stage it is difficult – and would be most likely inaccurate – to present a comprehensive explanation as to why Poland, according to the Eurostat, is the only country in the EU-27 which did not experience a negative growth rate at the end of 2009. It certainly shows that macroeconomic fundamentals remain to be important even after joining the EU, while avoiding uncontrolled borrowing on the European and international financial markets by the state, the banks, firms and consumer, as many other countries in the region did after the enlargement. But as I said, this analysis deserves some precise explanation. For that part, a high budget deficit of six percent and comparatively high unemployment in 2009 are certain signs that we should remain careful not to jump, once again, to too many conclusions about the examples of success stories in the midst of the international financial and economic storm.

Poland is a very interesting and in many ways most revealing example throughout the period of transition. Its experience with two decades of transition and integration into the EU was as dramatic as in other transition countries. In addition, during the last two decades Poland has tried several different approaches toward reforms, which is why it deserves special attention. Former finance minister of Poland, Grzegorz Kolodko, pointed out that there were at least five distinctive periods from the viewpoint of economic growth. In the entire period there was intensive debate between orthodox and heterodox economic and policy measures. There was a constant shift not only between policy measures and goals, but also a distinctive shift in theoretical assumptions and premises which characterized and influenced the entire process (Kolodko 2009).

Without going into a detailed analysis of various distinctive periods of the entire process to date, certain observations relevant to our discussion on the future prospects and possibilities for the countries in the Western Balkans are worth mentioning. One of the key

lessons of the entire period of transition, from Russia to Poland or any other transition and post-transition economy, is that institutional design does matter. This sounds today as an obvious and self-evident truism, but such a claim was far from widely shared and accepted a decade or two ago. At that time the prevailing and dominant view was that the spontaneous market processes, free from intrusive government intervention, present the best possible assurance for rapid economic and social development. At that time it was also widely believed that the initial allocation of incentives, rights and claims is less important, while more important is the speed of reforms regardless of how and to whom we allocate initial entitlements. Finally it was believed that the government has to provide a stable macroeconomic framework and refrain from unnecessary and arbitrary interfering with the market forces.

As it turned out in real life, it has become clear that the modern market economies and knowledge-based economies – with which all of the transition economies were hoping to become compatible – are significantly more sophisticated in terms of institutional design, in terms of providing a subtle regulatory and supervisory framework, and various forms of cooperation and exchange between the public and private sector. For example, rapid and unconditional withdrawal of governments from running previously state-owned enterprises, combined with various forms of external shocks, such as liquidity crisis due to the strict monetary policy, change of banking credit policy in the midst of uncertainties, immediate withdrawal of state subsidies and the emergence of inter-enterprise arrears led to the surge of bankruptcies. In the midst of uncertainties, accompanied by high interest rates, liquidity crisis and arrears, it was not possible to simply decide which of the firms were potentially viable on the markets and which firms should be bankrupt. Hardening of the soft budget constraint is one matter, but completely another issue is to decide which of the formerly state-owned enterprise should be restructured and which should go bankrupt.

Capital markets, which were established in the same period of massive privatization, faced similar problems. The poor initial regulatory framework and weak supervision of the newly established capital markets did not help to create a transparent and efficient process of mass privatization. Such a design of privatization could not address one of the key problems of efficient corporate governance: how to tackle the principal-agent problem. This is a problem well known also in the most developed capital markets. The difference is, however, that despite all of the deficiencies the advanced capital markets provide a significantly higher

level of expertise from all kinds of participants and regulatory bodies, which was not the case in the early, but highly important, period of transition. As a result, poorly regulated and supervised capital markets further exacerbated the already poorly designed and equally poorly implemented process of mass privatization. Overly simplistic understanding of the supposedly spontaneous market forces prevailed over the more sophisticated view of the modern market economy, characterized by its regulatory and institutional framework, and by many highly informed and developed actors. Of course, the recent financial crisis adds many additional question marks to the latter claim, but they are not directly related to the issues and challenges of the transition economies.

In the process of mass privatization Poland again presented an interesting partial exception. Unlike the mass privatization process in, for example, the Czech Republic, the entire process of privatization was significantly delayed due to the political struggles in the highly volatile and fragmented political situation in Poland.

Since the privatization program was not a part of the initial macroeconomic program, it allowed policymakers to carefully design a program in which not only the distribution of vouchers was the goal, but also several other goals were pursued. These other goals included restructuring the firms that were selected for privatization, strengthening managerial skills, filling the governance vacuum, and establishing links with foreign fund managers (Kolodko and Nuti, 1997). What made the Polish approach to privatization particularly interesting was the fact that the discussion on privatization was opened to the public.

A good overview of this complex process is presented in a study by Liberman, Nestor and Desai (1997) and Kolodko and Nuti (1997). After lengthy discussion and years of delay, the privatization program in Poland was implemented in the summer of 1995, when all the controversies were removed and the supportive laws were adopted. The delay in designing and implementing a privatization program in Poland had, according to commentators, quite a few important – although somewhat unintended – positive effects. Unlike the Czech Republic, where regulators usually stepped in *ex post,* in Poland the relatively complete regulatory framework was ready before privatization took place. The intermediaries in Poland were carefully designed and implemented "from top down," by the establishment of 15 investment funds, with each holding a controlling block of shares (33 percent) in about

35 enterprises while also holding minority stakes in other enterprises. According to Nestor, the 15 investment funds in Poland had two main, but conflicting goals. One goal was to secure strong corporate governance, and the other was to protect the minority shareholder - citizens. The top-down approach in the regulated environment did not seek for auction rounds, but it determined that each citizen ("buyer") was entitled to one share in each of the 15 investment funds. The firms participating in the process of privatization (around 500 large enterprises) were selected by the funds before the vouchers were issued to the citizens. More than 25 million participated in mass privatization through vouchers (95 percent of eligible citizens), which were selling on the Stock Exchange at ten times the fees to the authorized bank (state bank PKO, which distributed vouchers for a price at around 37 USD).

Investment funds attempted to function as the strategic owners of the firms and they had the incentives and capabilities to do so. The substantial stakes were assigned to each of the 15 investment funds, while their staff was partly chosen with the help of an international tender. Concentrated outside ownership, strict regulatory framework and careful selection of the fund managers gave investment funds sufficient capabilities and incentives to play strategic roles in firms. The transparency and disclosure rules gave NIFs important advantages over the Czech IPFs. The stakes of privatized enterprises were assigned to individual NIFs and were chosen by lottery, and for each firm the ‘lead fund’ was selected, whereas the rest of the funds became minority owners of the selected firm.

To summarize the Polish example from the viewpoint of comparative institutional reforms, there are many interesting examples that deserve to be put forward. In the first place, we saw major government programs, such as mass privatization, the creation of capital market, and banking-led conciliation that were implemented successfully. The strength of these programs was a strong regulatory framework, prepared in advance, and a carefully chosen institutional framework, responsible for the successful implementation of government programs. Outside the government-launched programs, there were many uncontrolled, spontaneous and unplanned processes in the reorganization of the existing economic links, although on balance it seems that the government was capable of managing the transition. It was capable of designing and implementing many complex and highly demanding programs, even though it had weak support from the parliament, especially in the early 1990s before the electoral reform took place. On the other hand, the government delayed with many of the announced and planned reforms. The most peculiar

aspect of the reform efforts was the long delay in preparing and implementing the privatization program. It started only after the economy had already picked up and recorded high growth rates. As such, the case of Poland deviates from the general understanding that privatization was the central part of the transition, without which any corporate restructuring and economic development could not have taken place.

Even Poland, as an interesting partial exemption to the general pattern of transition economies, cannot be viewed as an overall success example of transition and integration. It is possible to agree with Kolodko who maintains that Poland represents a ‘two third’ success with too many missed opportunities and costly policy mistakes to be able to ahieve a higher level of competitiveness in the European and international arena (Kolodko, 2009). The jury for the Central European countries, regarding their abilities to reach the long-term strategic goals of becoming part of the advanced, highly competitive and innovative, knowledge-based economy, is still out. There seems to be a period of rapid growth and convergence, however, various kinds of international crises and global pressures seem to push back these countries and expose their socio-economic vulnerabilities.

To complete an overview of the period of transition and integration of the Central European countries, certain important insights should be put forward. First, there was a confusion of goals and instruments, especially in the early stages of transition. In the early stages of transition, there was a belief in the automatic positive outcome of certain reforms, for example that rapid and mass privatization would automatically lead to higher levels of productivity and efficiency of newly privatized firms. In the early stage of transition many of the privatized firms did not perform significantly better than those firms that were yet to be privatized. Second, in the absence of a coherent regulatory framework, mass privatization resembled more a struggle for redistribution of economic and political power than a long-term strategic goal of enhancing the productivity and efficiency of businesses and economies. Third, mass privatization is not a goal in itself, it is a means toward broader goals of economic development. Of the required institutions one need only point to an efficient judiciary to protect new shareholders, large and particularly small, from various forms of asset stripping by various levels of old and new managers. In addition, various classes of creditors and investors, suppliers and consumers must be sufficiently protected to engage in a long-term productive relationship with such newly privatized firms. Complex rules of securing fair competition in the emerging market economy, allowing fair competition between

old, predominantly state-owned enterprises and new, privately established concerns must be in place prior to any large-scale attempt at privatization. Fourth, the role of the government does matter in all stages of transition and institutional transformation. Not in a traditional interventionist manner, but as a strategic partner to entrepreneurship, innovation and growth. Fifth, the initial allocation of entitlements and incentives does matter. Wrong incentives can lead to rent-seeking and asset stripping, instead of economic restructuring and long-term productive investments.

In which circumstances a much more nuanced, more imaginative and transparent approach toward comprehensive reforms can yield better overall results depends crucially on the comprehensive institutional framework. In the absence of organized civil society, pro-growth and development oriented political parties, in the absence of a strong, independent and initiative middle class, a state alliance between rent-seeking and the well entrenched interests of the newly privatized segments of society can emerge. Such an alliance can in return resist and suffocate initiatives and pressures from the weak civil society, groups of workers and the tiny middle class, it can resist and shield from the international pressures. It can, however, present a major obstacle to more dynamic and innovative development under any institutional setting, even after formal integration into the EU. Concentration and consolidation of the property rights in the hands of a small number of insiders, usually politically well connected, as an outcome of transition can present a major impediment to overall progress. On the other hand, there were many privatization surprises, such as a relatively successful performance of employee-owned enterprises and those that remained temporarily partially owned by the state. Alternatively, open, inclusive, fragmented entitlements can broaden and deepen economic and entrepreneurial opportunities for many new potential entrants to the market. After two decades of transition and integration it is possible to say that only an alternative institutional framework, hospitable to initiatives and able to support them, can lead to a more dynamic, innovative and inclusive society.

Even a recent study on the effects of privatization in transition economies confirms that the privatization itself does not guarantee improved performance, at least in the short and medium run (Estrin et al. 2009, 27 – 30). It requires a more stimulating institutional framework, more pluralistic view of the property rights and entitlements, broader access to productive and financial means as well as improved diffusion of knowledge, technologies and expertise. In other words, in societies with the transparent and accountable public sector the

relation between the public and private, between the government and the firms can represent a virtuous circle, in which privatization is only one of the tools for overall development; whereas in societies with little public transparency and accountability the relation between the public and private represents a vicious circle, dominated by privileged insiders and rent-seekers.

CONCLUSION

There were many surprises, unexpected and undesired consequences of the mass privatization in Central and Eastern Europe. The most important conceptual confusion of the first and second generation of reformers was the superficial belief that the privatization would automatically solve the issues of restructuring, improve productivity, stimulate innovations and improve overall governance of the companies. The privatization has become a goal in itself not as a mean to improve competitiveness, as succinctly observed by Joseph Stiglitz, who was a chief economist of the World Bank at the peak of privatization efforts in transition economies (Stiglitz 1998, 6). Moreover, the superficial belief that mass privatization would be a panacea for the transition economies was accompanied by equally superficial belief that more important than the quality of privatization in the form of transparent, regulated and strategic approach is the speed of privatization. As a consequence, the outcome of privatization was too often less than optimal, accompanied by massive frauds in absence of strong regulatory framework, supervision and detailed information.

In the described context the widespread expropriation methods – also labeled as 'tunneling out', outstripping assets, or self-dealings – took place. One of best accounts of such technology was provided by John C. Coffee in his analysis of the technology and ease with which the assets could have been looted. The simple, but effective methods and tactics of the 'tunneling' carried out by the privileged insiders and various classes of shareholders were capable of insulating their activities from the judicial scrutiny (Coffee 1999, 26-27). Therefore, it did not come as a surprise when the OECD report for the Czech republic in 1998 pointed out that the Czech voucher approach to privatization produced ownership structure that impeded efficient corporate governance and restructuring (Nellis1999, 11)

The described conceptual and practical deficiencies and flaws of the mass privatization in Central and Eastern Europe does not mean, however, that the privatization is not an important instrument in an effort to secure more productive, more innovative and more competitive firms. In doing so we need to bear in mind that the more imaginative, more

sophisticated approach needs to be taken. After two decades of experience with the privatization and the behavior of post-privatized firms it is possible to argue that there is no one single ideal model of ownership which could guarantee long term successful development. At the same time it is also safe to claim that certain types of ownership are more likely to lead to a successful long term development of the firms than others. As mentioned above, John Nellis, referring to an interesting insight by Mary Shirley, made probably a crucial insight into the paradoxical nature of privatization: "the irony is that the countries with the administrative skills and political capacity to run state-owned firms in an effective and efficient manner are usually the very same countries that can privatize well. Conversely, the forces and conditions that lead governments to botch privatization are the same that hinder decent SOE management" (Nellis 1999, 22). In other words, there are countries and their institutions with sufficient skills, capacities and broad public support to be able to do both, to secure efficient and transparent governance of the state-owned companies and to provide competitive environment for the long term success of the firms on the markets and there are countries which do not possess high quality of public and private institutions and therefore can make a mess of both, state-owned and privatized firms.

In his another comparative empirical study John Nellis on the behavior of the privatized firms made another important observation. The issue which type of the firms is the most productive and dynamic, he has pointed out that many studies from transition ranked new entry – or "de novo" firms as the most productive and dynamic; then privatized companies, and last, state-owned firms. The gap between the *de novo* set and the privatized is often larger than between privatized and state-owned (Nellis 2006, note 32). Other studies have analyzed what kind of privatized firms (for example, with outside strategic owners, employee owned enterprises, inside managerial owned firms, dispersed ownership) perform better. This is a significantly more complex issue, because the answer depends on the quality and development of financial markets, on the quality of regulatory bodies and other supportive institutions, including the quality of legislation and judiciary. Furthermore, it depends on the issue whether the firm needs strategic restructuring with the support of external funds or it needs defensive restructuring relating to redundancies and other cost cutting measures may also play a role. The existence and level of competition, openness to foreign competition and foreign investors clearly also plays a role. In such a complex context it is not possible to provide simple answers which types of ownership and which type of ownership coalitions may be successful for the long term development of the firms and which may present an impediment.

The answer to this question is not conclusive and it probably cannot be conclusive. There are certain elements and patterns, however, which should not be ignored by any more subtle generation of policy-makers and true reformers. As mentioned above, the importance and relevance of the newly created firms appears to be critical if we want to create a dynamic, innovative and competitive environment. The sustained, systemic support for the establishment of new firms should be one of the key strategic goals of any genuinely pro-development oriented policy makers. The next important insight was offered again by John C. Coffe who found strong correlation between the legal protection of shareholders and the size, depth and liquidity of securities markets (Coffee 1999, 5). He also believes that the correlation is mutually reinforcing and therefore encouraging capital market growth and ownership dispersion. Relating to the problem of powerful insiders Gerard Roland has pointed to the risk that they are in a position to pursue asset stripping to the detriment of minority shareholders. This can happen either in case of strong and unaccountable managers due to the dispersed ownership with weak legal protection or in the case of concentrated inside ownership which may lead to the similar outcome (Roland 2000, 332-333).

In short, the literature on the relation between privatization and corporate governance in Central and Eastern Europe is comprehensive, and as rightly pointed out by Gerard Roland, astonishingly diverse (Roland 2008, 32). It is due to the complexity of the process and due to many difficulties in methodological analyses of this unique historical process. There is no doubt that privatization, if well thought out, well regulated and well implemented, can lead to improvements in corporate governance, productivity, profitability and has positive impact on other important indicators of corporate development. On the other hand, there is also little doubt if poorly prepared and implemented it can lead to dramatic failures and disappointments.

The success of privatization is a deeply contextual matter. In the environment conducive of long term development privatization, if properly designed and implemented, can work. In the environment, conducive to rent-seeking, the results can be exactly the opposite: the forestalled development and exclusion of majority of stakeholders. In order to avoid the detrimental outcomes of poorly designed privatization the broad coalition of balanced and diverse stakeholders could be the coalition, supportive of such long term development goals. For example, a series of overlapping and competitive holding companies, representing the interest of both insiders (workers and managers) and outsiders (local governments, social

organizations, fragmented shareholders, foreign investors) would pool the equity stakes in the privatized firms. The shares in the ownership companies of productive enterprises would be distributed among these holding companies to ensure that one such company would hold an influential but not an irresistible stake in each firm. The shares of the holding companies could be traded on a mass individualized market in shares. The shares of the productive firms, on the other hand, could be traded on a more closed institutional market in which only the holding companies themselves, banks and foreign investors participate. This two-tier market system allows for a closer coordination between ownership and control and establishes greater parity among the multiple institutional owners of firms (Unger 1998, 97 – 101).

Such a thought experiment about the alternative method of privatization should remind us not only that there is single ideal model of privatization, but there is no single universally valid definition of the property right. Property rights can and should be understood as a bundle of rights (for example, right to control, cash flow rights) and can be assigned in many different ways to various stakeholders. The proponents of clearly defined property rights obviously have difficulty explaining the Chinese economic success in the environment of poorly defined property rights. The debate on the disagreggation of the property rights should not be an ideological one. It should be a debate on how to open up access to economic opportunities of large segments of population and how to organize institutional framework in such a way to secure inclusive, dynamic and innovative long term development and growth.

In order to rescue capitalism from capitalists we need to transform the oligarchic property rights, created in the period of transition by imposing real capitalism on capitalists. The ability to create more democratic property rights in the sense of its openness of access to various actors and stakeholders is of crucial importance. Instead of creating rent-seeking coalitions, unable and not interested in long term development of the privatized companies we need to create more diverse and more balanced coalitions of stakeholders with the stakes in long term success of restructuring, innovations and improvements. There is no guarantee that all the types of coalitions will be successful, but the opportunity to create more development friendly, more inclusive and sustainable corporate structure and overall economy may emerge. Collective learning efforts and establishment of links between corporate governance and organizations of production as well as establishment of development coalitions inside and outside the firms may unleash new productive and creative forces in transition and post-transition economies and societies.

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