7. Privatization and restructuring.

Big debate in the beginning of transition on privatization. Absence of preexisting wealth in population required developing new methods.

Proponents of mass privatization (giveaway schemes) emphasized speed.

Opponents emphasized economic efficiency and revenue maximization.

One could have invoked the Coase theorem to claim that methods are irrelevant and that the market would eliminate initial inefficiencies. This did not happen

Different approaches.

- sales vs giveaway.
- cash vs non cash sales (debt, instalment, non monetary pledges)
- transfers to outsiders or insiders.
- top down vs bottom up.

Different methods

	Top down	Bottom-UP
Giveaway to insiders	Russia	
To outsiders	Czech republic	
Sales to insiders		Poland (non cash), Hungary (non cash)
To outsiders	East Germany	Estonia (non cash)

Private Sector Share in GDP.

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Poland	30	40	45	50	55	60	60	65	65
Hungary	25	30	40	50	55	60	70	75	85
Czech republic	10	15	30	45	65	70	75	75	75
Slovenia	15	15	20	25	30	45	45	50	50
Slovakia	10	15	30	45	55	60	70	75	75
Bulgaria	10	15	25	35	40	45	45	50	65
Romania	15	25	25	30	35	40	60	60	60
Russia	5	5	25	40	50	55	60	70	70
Ukraine	10	10	10	15	40	45	50	55	55

Source: EBRD Transition Report (1999)

Cumulative privatization revenues (as a % of GDP).

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Poland		0.2	0.6	1.1	1.9	2.8	3.8	5.3	6.7
Hungary		0.1	1.2	1.8	2.7	5.9	9.6	12.6	13
Czech republic					1.6	2.6	2.8	3.3	
Slovenia						0.4	0.8	1.3	1.8
Slovakia			3.7	4.8	6.9	9.4	11.4	11.9	12.3
Bulgaria				0.4	1.5	0.9	2.9	5.6	5.3
Romania				0.1	0.4	1.2	2.2	4.1	6.1
Russia			0.8	1.1	1.3	1.5	1.7	1.7	2.3
Ukraine				0.1	0.3	0.4	0.7	0.8	1.3

Source: EBRD Transition Report (1999)

Objectives of privatization:

- Better matching between managerial talent and productive assets
- Better incentives.

Which one is the most important?

Empirical evidence: matching more important.

Constraints facing privatization policies:

- stock-flow constraint.
- Fiscal constraint
- Political constraints
- Informational constraints
- Administrative constraints

- Restructuring tasks depend on
    1) degree of product competition
    2) skills of incumbents
    3) needs for external finance
    4) degree of firm independence from government

1) Degree of product market competition.

Carlin et al. (1994): firms with dominant position do not restructure.
Privatization helps if managers not residual claimants
Privatization does not help if rent-seeking more profitable
Segal (1993)

<u>Efficiency</u> requirement: demonopolization.

Political economy constraint to demonopolization =>
Better to demonopolize earlier (Tirole, 1991).

Mistake in Russia!

2) Heterogeneity in managerial skills.

• Distinguish between defensive and strategic restructuring (Grosfeld and Roland, 1997).

• Bad managers lose from strategic restructuring
=> No incentives possible for defensive restructuring.
Early privatization may enhance incentives for asset-stripping (Aghion, Blanchard and Burgess, 1994)

<u>Efficiency</u> requirement: replace management.
Political economy constraint: overcome resistance to layoffs.

• Good managers gain from strategic restructuring but may face different costs from defensive restructuring.

<u>Efficiency</u> requirement: give incentives for defensive restructuring.

3) Need for external finance.

• Firms with no retained earnings

Raising outside funds requires giving up control rights.

• Firms with retained earnings.

Moral hazard problem of empire-building.

<u>Efficiency requirement</u>: give control to outsiders.

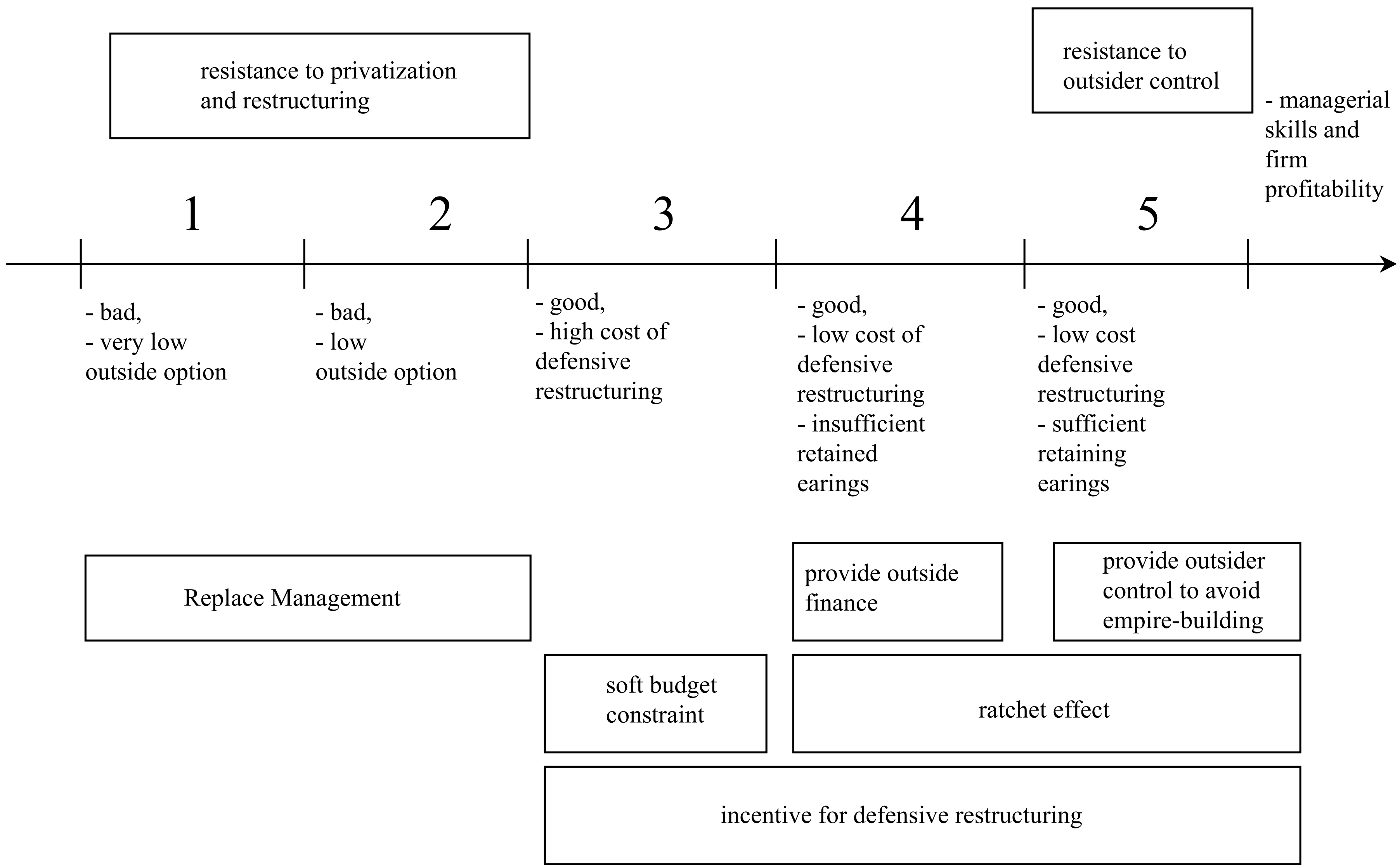
Political economy constraint: overcome resistance from empire-builders.

4) Degree of firm independence toward government.

- Government intervention in firms (ratchet effect)
- Rent-seeking by firms (soft budget constraint)

<u>Efficiency requirement</u>: mechanisms for government commitment.

NB: Weakening government reduces intervention but may increase soft budget constraints.

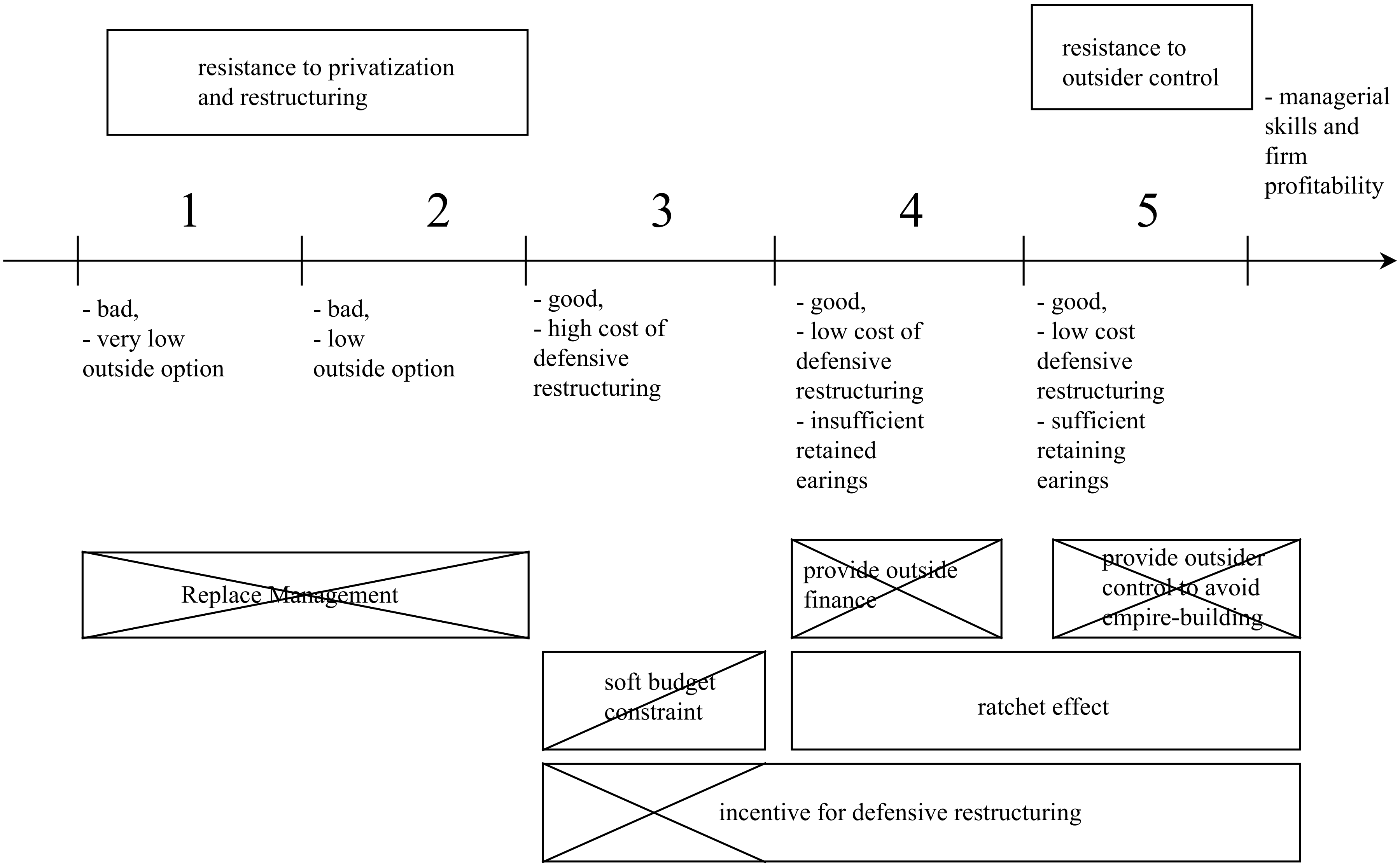

resistance to privatization and restructuring
resistance to outsider control
- managerial skills and firm profitability
1
2
3
4
5
- bad,
- very low outside option
- bad,
- low outside option
- good,
- high cost of defensive restructuring
- good,
- low cost of defensive restructuring
- insufficient retained earings
- good,
- low cost defensive restructuring
- sufficient retaining earings
Replace Management
provide outside finance
provide outsider control to avoid empire-building
soft budget constraint
ratchet effect
incentive for defensive restructuring

4. Consequences of privatization policies on corporate governance and restructuring.

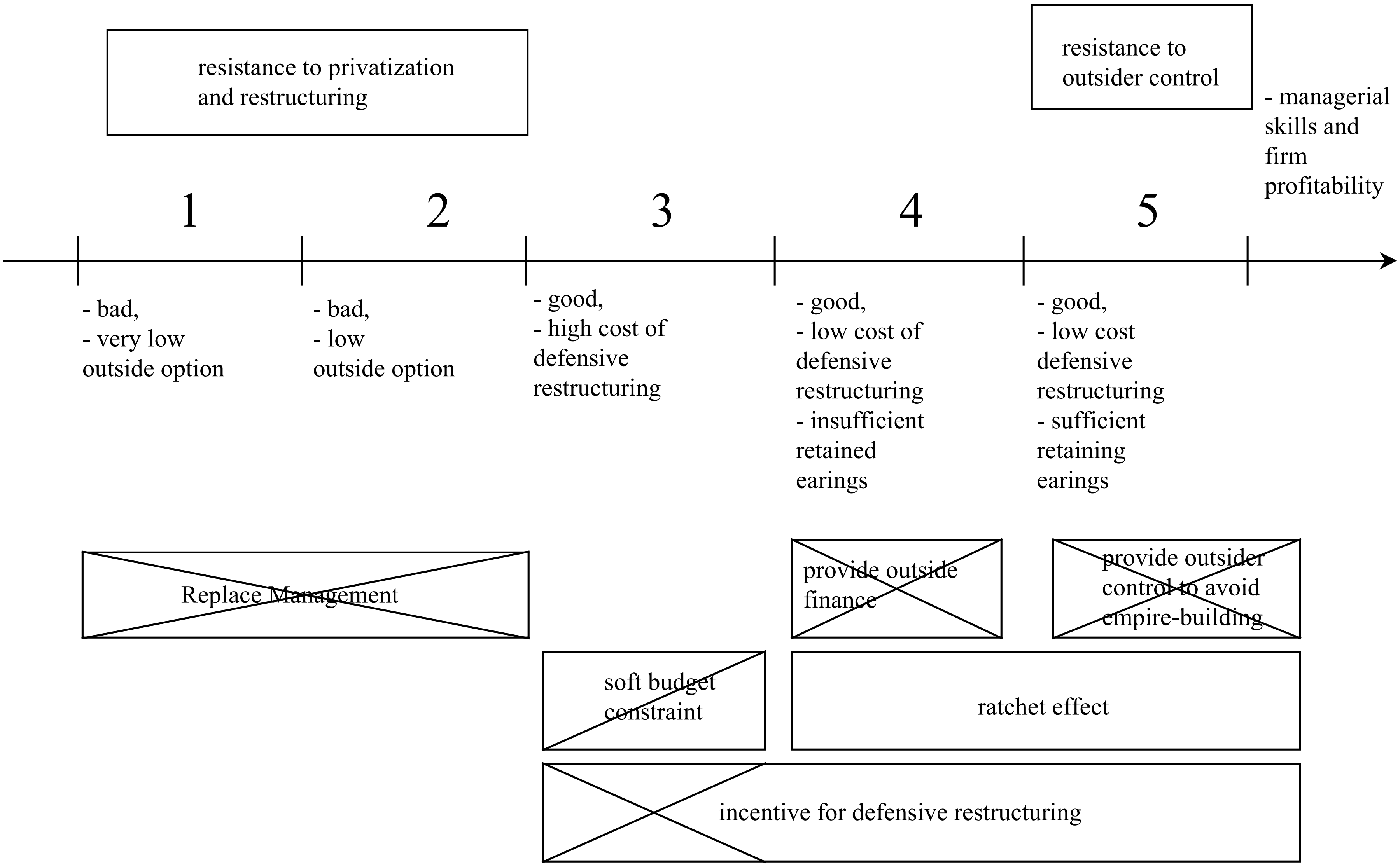
Distinguish

- fast giveaway to dispersed outside owners (Czech republic)
- fast giveaway to insiders (Russia)
- top-down sales to outsiders (East Germany)
- bottom-up gradual sales to outsiders (Poland, Hungary)

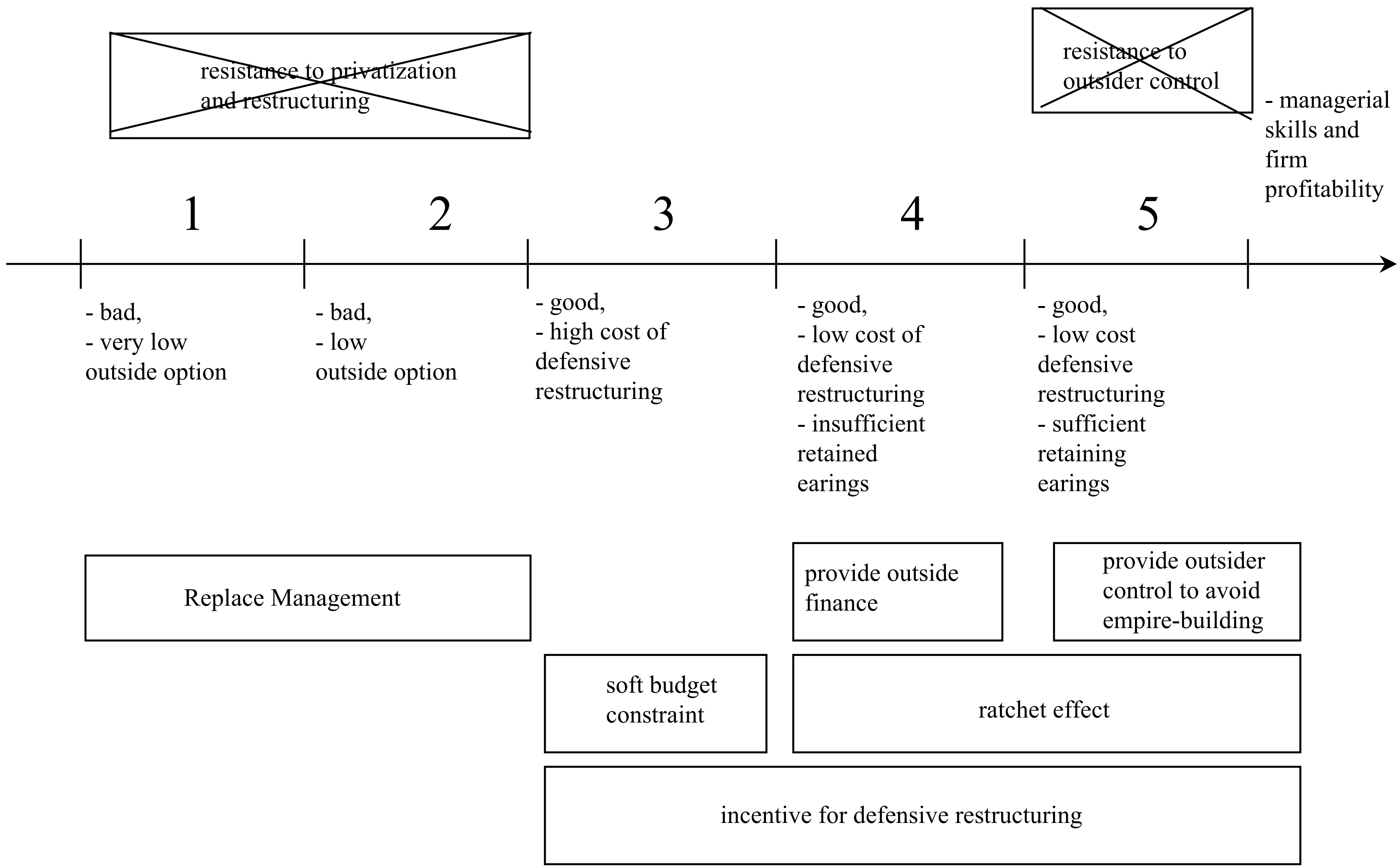
Fast giveaway to dispersed outside owners



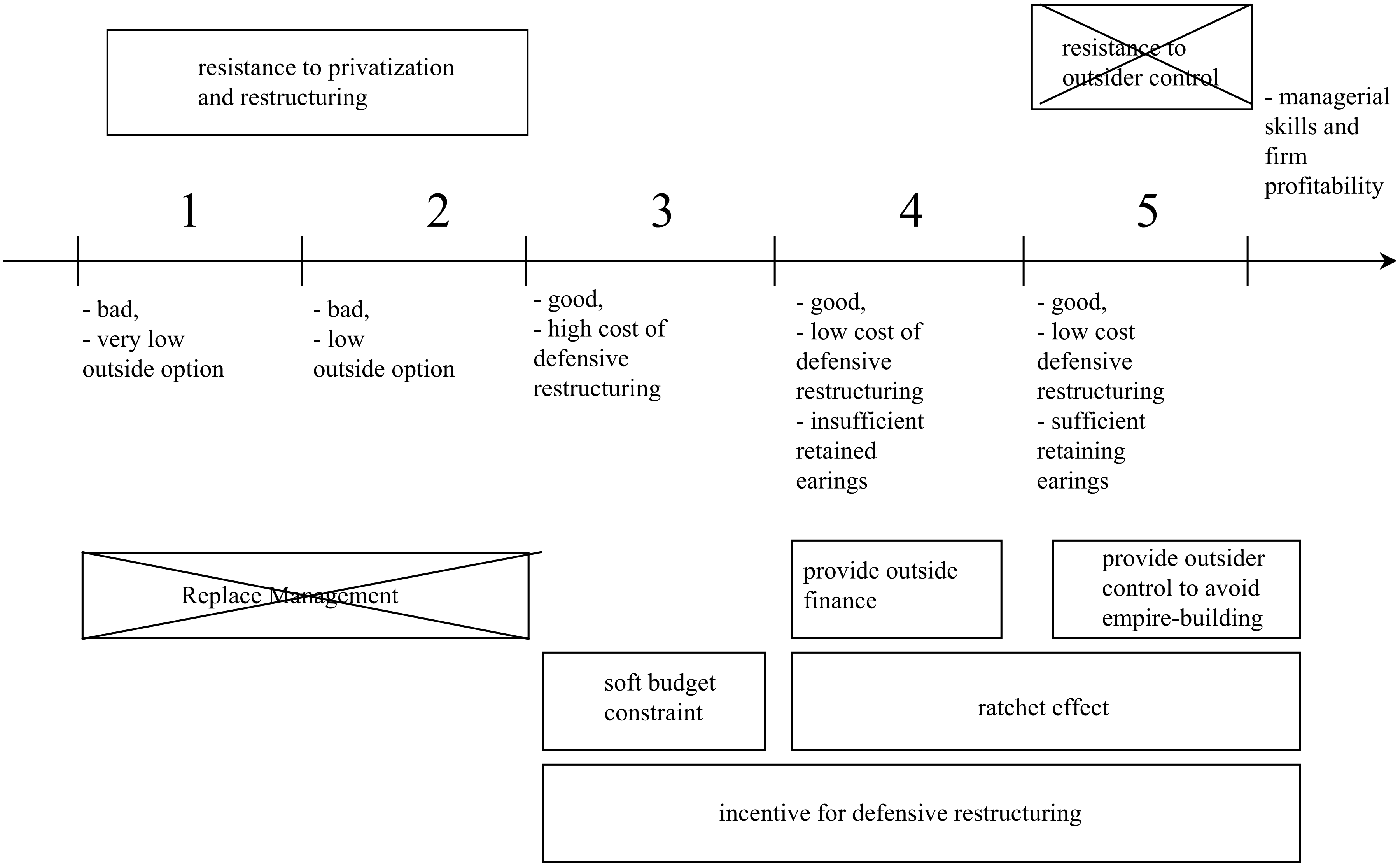
Fast giveaway to insiders



Top-down sales to outsiders



Gradual sales



Summary Effects of privatization policies.

	mass privatization to dispersed outsiders (Czech republic)	mass privatization to insiders (Russia)	Top-down sales to outsiders (East Germany)	Gradual bottom-up sales to outsiders (Poland, Hungary)
Objectives: - replace management	No	No	Yes	No
- defensive restructuring	partial	partial	Yes	gradual
- outside funds and control	No	No	Yes	gradual
- hardening budget constraints	Partial	Partial	Yes	gradual
- prevent asset-stripping	No	No	Yes	partial
Political Constraints: - resistance to redundancies	Yes	Yes	No	Yes
- resistance to empire-building	Yes	Yes	No	No

5. Dynamic effects of differences in initial allocation of economic power generated by privatization

- Difference in economic power of individuals under state and private ownership.

- Mass privatization creates strong and sudden concentration of economic power; gradual sales do not.
- => scope for abuse of power w.r.t. minority shareholders => low stockmarket confidence and liquidity => formation of large business groups with further concentration of power
- => capture of state => (corruption, weak tax and law enforcement, development of mafia networks, legal reform blocked, inflationary dangers).

- => high wealth inequality => political instability => short-termism and asset-stripping $\nearrow$

=> mass privatization => lock-in in corporate governance system with low stockmarket liquidity, large business groups, weak law enforcement and political instability.

In Czech republic, entry in EU helps, but in Russia ?

Gradual sales create less sudden concentration of economic power but give time for private capital accumulation based on new private sector (SME's).

SME's become small investors with interests to defend.
SME's main constituency for further reforms and shrinking of state sector.

Pressure from SOE's for soft budget constraints remains a problem but can be gradually reduced via strength of private sector.

General lessons.

- Heterogeneity in restructuring tasks facing firms.
- Importance of initial choice of privatization policy. Effects not only on restructuring outcomes but also on economy-wide performance and evolution of institutions.
- Mass privatization creates strong initial concentration of economic power in hands of insiders
  => evolution toward large business empires, small stockmarkets, weak and captured governments, political instability.

- Gradual sales have lower initial concentration of power, rely on entry, learning and private capital accumulation, SME's as constituencies for further reform. Create economic safeguards against asset-stripping. Natural evolution of capitalism instead of jump-starting capitalism.