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Privatisation in the former Soviet Bloc: Any lessons for China?

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Summary

- China is privatising its state enterprises. Although the starting conditions, both economic and political, differ vastly, lessons can be learned from the privatisation experience of the former Soviet bloc.
- The experience of Eastern Europe shows that privatised firms perform better than firms where the state retains control. In addition, firms sold to outside investors (particularly foreigners) do better than those taken over by insiders; firms sold at auction do better than those sold through tender and those bought by insiders; and creating a secondary market in assets is crucial.
- Small- and medium-sized firms in China have mostly been restructured through employee buy-outs and, as in Russia, this has not facilitated restructuring. China's reforms to its large-scale firms, delaying as they do transfer of ownership, are sub-optimal in terms of encouraging improvements in firm-level efficiency. Instead of continued state ownership, sales of controlling stakes to outsiders, which are transparent, competitive, and open to foreign bidders, would be a strategy worth exploring for most state firms outside the utilities sector.
- Given its competitive markets, low entry barriers, a relatively well-developed class of private buyers, a relatively advanced legal framework, openness to foreign investment, a capable government administration and time and resources enough to organise sales properly, China is uniquely positioned to organise a large-scale and successful privatisation programme.

This briefing note is based on a longer working paper also available on the Chatham House website (www.riia.org). A future briefing note will look at China's current privatisation programme.

What does privatisation hope to achieve?

Privatisation, the transfer of ownership rights from the state to the private sector, aims to achieve up to five things: to increase enterprise efficiency, to stimulate the emergence of asset markets, to limit corruption, and in some cases to support democracy and restore stolen property. First, the majority of economists believe that private ownership is generally superior to public ownership, so privatisation should improve enterprise efficiency. In a plan economy multiple state agencies take responsibility for administering firms, but none assume responsibility for the efficiency with which the firm employs its factors. Privatisation creates owners who profit (and lose) as the firm succeeds (and fails), and this creates incentives for responsible management. It matters less whose hands the assets initially fall into after the sale since the market, and hard budget constraints, should ensure that the assets end up in the hands of those who use them most productively.

Second, privatisation's most important effect in the short-term is that it stimulates the development of markets, markets for land and industrial plant (the things that privatised state-owned enterprises (SOEs) sell) and factors of production (which SOEs previously monopolised). Third, given the reduced ability of bureaucrats to monitor the behaviour of managers in a post-plan economy, assets can be easily transferred out of the SOEs by their managers, and bankruptcies can be 'faked' in order to facilitate asset stripping. Privatisation limits such corruption by clarifying property rights, formalising asset sales and ensuring that revenues flow to public budgets.

In addition, in the former Soviet bloc privatisation was also used to support democracy. Putting assets into the hands of private business, however corrupt the process, weakened the state, making a return to communism – a real and present danger for Russia and other central-Asian states in the mid-1990s – less likely. Lastly, ownership reform was meant to restore what was stolen. The widespread restitution of property expropriated by communist governments occurred in the Baltics and East Germany, and farmland was given back to farmers in much of central Europe.

How was privatisation done in the former Soviet bloc?

All post-communist states, with the exceptions of Hungary, East Germany and Azerbaijan, implemented some form of mass privatization programme. Mass privatisation is broadly defined as selling as much as possible of the state's property as quickly as possible, leaving restructuring to the new owner. Privatisation of small-scale industry was relatively easy to organise. Local government was empowered to organise auctions or authorise employee and management buy-outs (EBO/MBOs). Most small and medium enterprises (SMEs) in Eastern Europe and Russia were sold to insiders. The privatisation of large-scale enterprises was more difficult – large concentrations of assets had to be defined, broken up, evaluated, audited and sold. Demand had to be nurtured and regulatory frameworks created.

Each country pursued its own particular privatisation strategy for large firms. There was a huge variety of different sales methods, sequencing and institutional frameworks employed. This was partly due to the fact that the political, economic and institutional legacies of each country differed, and these legacies narrowed the options available to policy makers. Moreover, neither the policy makers nor their advisors at the multilateral institutions like the World Bank had any experience in organising corporate restructuring on this scale. The lack of a 'best practice' privatisation template spawned experimentation and a willingness to accept ad hoc arrangements.

Public share offerings

Public share offerings have a number of advantages: they are open to everyone, transparent, market-based and can maximise government revenues. The initial public offering (IPO)

method was unfeasible in most countries for a number of reasons: it required firm extensive restructuring could take place before the sale (which a weak state was unable to organise); it was expensive to organise; and firm insiders had few incentives to support it.

Direct sales and investment tenders

Used on a large scale in East Germany, Hungary, Estonia and Bulgaria, one of the main advantages of direct sales of large blocks of shares is that they transfer control over the enterprise to new owners, thus creating incentives to restructure the firms. They can also raise considerable revenue for government. However, direct sales tend neither to be transparent nor to dis-encourage corruption – they are often little more than give-aways to the rich and well-connected.

Vouchers

The distribution of vouchers that can be exchanged for shares was the dominant privatisation method in the Czech Republic, Lithuania, Latvia, Kazakhstan and initially also in Slovakia. Vouchers were initially popular with politicians since they were cheap, simple and popular among voters. They also allowed rapid privatisation – a useful political outcome for governments fearing a return to Communism. However, with ownership so widely distributed among thousands of voucher buyers, control rights were dissolved and no new 'owner' was created. As a result little corporate restructuring occurred. Fourth, this sale method raises no revenue for the government.

Management and employee buy-outs

Administratively fast and easy, MBOs and EBOs were the dominant form of privatisation for SMEs in Poland, Romania, Slovakia, Russia, the Ukraine, Moldova, Georgia, Tajikistan and Uzbekistan. The method works easily for small firms since insiders can raise the requisite finance. However, the MBO and EBO methods suffer a number of disadvantages, including low prices paid by insiders, selection bias (the best firms tend to be EBO/MBO self-selecting, leaving the worse firms on the government's books) and poor corporate governance structures.

Bankruptcy and liquidation

Only Estonia used bankruptcy and liquidation as an overt reform strategy. It has a number of clear advantages. A credible threat of bankruptcy creates incentives for owners to better manage their assets. If liquidation does occur, then it facilitates a thorough restructuring of assets, creates markets in these assets, and enables new owners to take full control of a clearly-defined business.

What lessons were learned?

Given the results of numerous surveys others, some core lessons can be learned from the privatisation experience of the former Soviet bloc (FSB).

1. **Sell as quickly as possible.** There are hidden costs associated with waiting to privatise: asset stripping continues, institutional development has no driver, and little corporate restructuring takes place.
2. **But go slow with monopolies.** When dealing with natural monopolies and oligopolies (e.g. utilities), one should privatise with great caution, if all. An efficient regulatory framework is a prerequisite to a sale.

3. **Create real owners.** It is key that a new owner, with de facto control rights, is created. Outcomes were best when ownership was concentrated in a small number of shareholders rather than dispersed among many.
4. **Place constraints upon the new owner.** Minority shareholders must be protected and the dominant shareholders prevented from asset stripping.
5. **Outsiders make better owners than insiders.** Outside investors are usually more willing to force through painful restructuring than employees and managers.
6. **Allow foreign investors to be owners.** Strategic foreign investors tend to perform better than domestic ones.
7. **However, do not get your hopes up for enormous flows of FDI – or revenues from domestic buyers.** Unless the rule of law and national treatment is a reality, foreign investors will be wary of making purchases.
8. **Strategic investors perform better than other types of outsider.** If possible avoid sales of controlling stakes to investment funds and holding companies. Both tend to be less interested in developing the substantive business of the firms they control. Private investors with a substantive business interest in the firm itself are best since they are more likely to actively restructure the firm.
9. **Use open and competitive auctions for the sale of large firms.** Since direct sales offer opportunities for corruption and have been shown to lead to poorer performance, competitive and transparent auctions for the sale of large state firms are recommended. In addition, the revenues raised are maximised.
10. **Or, if the institutional capacity is present, use IPOs.** Public offerings also tend to be transparent and can raise government revenues and so are a viable alternative to auctions for the sale of large firms. Care must be taken, however, that control does actually pass out of government hands. An initial IPO of a minority stake has to be followed by additional share issues, public or placed.
11. **Develop the institutions for a secondary market in ownership rights.** A liquid stock market, an effective M&A framework and working bankruptcy procedures are needed to facilitate the quick and easy transfer of assets to their most productive owner. Such a framework reduces the impact of the initial sale method since ownership can quickly change again.
12. **Introduce hard budget constraints as soon as possible.** Initial buyers have to face hard budget constraints (including a functioning bankruptcy framework) in order to force them to sell their newly-acquired assets if they are not being used productively.

Concluding remarks

The government of the People's Republic has implemented much of the Washington Consensus. Fiscal discipline, tax reform, trade liberalisation, deregulation, better protection of property rights, and lower barriers to entry for both foreign and domestic firms are all part of China's reform story. As for privatisation, China is about half the way there, though it is the more difficult half that lies ahead.

The best strategy is to transfer assets as rapidly as possible to individual investors or concentrated groups of strategic investors through open, fair and transparent methods. China's current de facto privatisation policies could be improved, especially for larger firms which are not as far advanced in their restructuring as small and medium-sized ones. More

open methods (including auctions) a faster sale process, greater access to foreign investors, a more market-based valuation framework, explicit national guidance on sales and more central government oversight of provincial sales would all help.

This would not only promote firm-level efficiencies; it would also support the market-based reform agenda. If large-scale corruption is allowed to exist in the enterprise reform process, this will undermine the government's legitimacy and would also damage confidence in market reforms. One day, China will experience a recession: a corrupt privatisation experience would inflame any backlash against marketisation, something that occurred in many parts of the FSB.

Despite the problems outlined in this note, overall, China is now in a unique position to effect a successful programme of sales. Company law, as well as frameworks for M&A activity, corporate disclosures, and sales to foreign investors are in place. Corporate tax and accounting regimes suitable for a market economy are also present. Institutional investors in the form of the investment fund management firms have developed – as well as regulation – and the prospects for funds to exert a positive influence are good.

This briefing note is based on a longer working paper also available on the RIIA website. The working paper tackles some of the criticisms that have been made of privatisation policies in the former Soviet bloc, examines China's current policies in light of these and provides a full list of the sources used in this note.

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