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FINAL REPORT

Privatization Phase I Program Evaluation:

Early Experiences of Privatization in Hungary, Poland, and the Czech and Slovak Republics

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Background

In September 1992, AID undertook to evaluate the progress made in the privatization programs for medium and large-sized State Owned Enterprise (SOEs), particularly industrial firms, in Hungary, Poland and Czechoslovakia. The evaluation, conducted principally by Price Waterhouse and selected consultants to AID, examined the environment in which these programs were developed, the tools used to implement them, and the impact of privatization on corporate governance and performance. The types of privatization methods examined here are the mass privatization programs in Poland and Czechoslovakia, and the methods of SOE management and/or worker initiated privatizations, also known as "internal" privatizations, in all three countries.

Other methods of privatization, such as small enterprise privatization and market based sales of medium and large enterprises, were not part of the specific scope of this AID evaluation. The World Bank, in consultation with AID, commenced a parallel study of these programs in the three subject countries.

Country Privatization Programs

Privatization has proceeded much more slowly than was originally envisaged by all three countries. For example, in Hungary, the government had hoped to privatize 80% of the 2,000 medium to large SOEs by the end of 1994; by January 1993, only 40 of these had been privatized. Equally optimistic timetables in Poland and Czechoslovakia were created and abandoned. After some early cases of large SOE privatizations in each of these countries (now viewed as problematic), a pattern has emerged in which the bigger the enterprise, the slower its privatization.

Hungary

Hungary was the earliest starter of privatization for medium and large scale companies -- originally relying on enterprise managers to initiate and implement both the transformation to stock companies and privatization. In 1989, the process, then known as "spontaneous privatization", was unregulated. This gave rise to a widespread criticism that the system was unduly biased towards enterprise management, allowing managers too much opportunity to appropriate state assets. These criticisms led to the establishment of the State Property Agency (SPA) in March 1990. The SPA was given the mandate to improve the monitoring and control of Hungarian privatizations, as well as to centralize and accelerate the process. The bureaucratic controls imposed over privatization programs served to slow the process. In late 1991, some elements of decentralization were subsequently introduced.

The total proceeds of privatization transactions under the SPA at December 31, 1992 was HUF 1362.3 bn, more than two times the book value of the privatized enterprises, HUF 645.5 bn. The SPA was not without its successes -- this represented nearly a 300 percent increase in the value of transactions closed by the SPA over the previous year. Most of this success has been at the small and medium-sized company level.

The SPA made little impact on the privatization of the larger SOEs. Out of a possible 2000 larger SOEs, only 40 were privatized by the end of 1992. Hungary has not yet created a mass privatization program, preferring a case-by-case approach to the disposition of state property. However, to allow SPA to concentrate on privatization activities, the Government created the Hungarian State Asset Holding Company (AVRT), in October 1992. The AVRT exercises governance and restructuring of those enterprises in which the state intends to maintain dominant ownership in the medium term. The 130 or so companies taken over by the AVRT produce in excess of 60 percent of Hungary's output.

Czechoslovakia

The CSFR's privatization program, now divided into separate programs of the Czech and Slovak Republics, has been very successful. By the end of 1993, 4,000 out of 7,000 large firms are expected to be privatized to some degree in the first and second waves of large privatization. In addition to more than 100,000 restitution claims settled, over 30,000 small firms were auctioned in the small privatization program. In the privatization process, foreign participation was also encouraged, and direct foreign investment amounted to $600 million in 1991 and $950 million in the first three quarters of 1992.

Despite many changes in regulations for potential investors, controversies and criticisms, privatization is supported by the public, especially in the Czech Republic. The rapid pace of privatization was facilitated by the original conception to allow new owners of privatized enterprises (and not government) to restructure. By mid-1993, 3900 private companies had been formed through the break-up of the 1872 medium and large SOEs in the first wave of privatization. Nevertheless, there clearly remains much restructuring work to be done.

The Czech case suggests that the political nature of the privatization process requires strong leadership, not only at the highest levels of government, but also at the enterprise level.
In the Czech and Slovak Republics -- far more than in Hungary or Poland -- there has been strong support for rapid privatization at both the government and the management/worker level, and it is there that the greatest level of success has been achieved.

Poland

Although there has always existed a base of private ownership in Poland, the transition of Poland's medium and large SOEs to private enterprise has been slower than Czechoslovakia's or Hungary's. A political tension exists between the centralist schemes of the post-communist governments, and the pressure of enterprise insiders to decentralize control over the privatization process is at the enterprise level. This conflict has created multiple rounds of compromise and inactivity. Delays also occurred as a result of the extensive sectoral studies which preceded the "sector privatization" process. The tension has been further exacerbated by political weaknesses/paralysis resulting from the absence of a stable parliamentary majority. The long debated Polish mass privatization program was not approved by Parliament until April 1993.

The range of privatization techniques adopted was designed to allow the government to formulate general privatization plans, and also to give management and workers a large degree of choice with regard to the program in which their enterprise would participate. The role of Solidarity in overthrowing Communism gave the Polish privatization program a strong egalitarian cast with particular emphasis on employee ownership. Initial expectations were that employee and management buy-outs would be very successful, but as of February 1992, the Ministry of Privatization listed only two companies with combined assets of Zl 93 bn as being partially privatized through this mechanism. The most common form of privatization in Poland has been a type of worker-management buy out achieved through the process of "liquidation." 1055 SOE's have been liquidated; the process has led to 545 new economic units formed by the employees by leasing the assets of the liquidated enterprises.

Corporate Governance

The initial expectation in Central and Eastern Europe was that privatization would have a dramatic and positive effect on corporate governance, not only on the structures of management, such as the creation of boards of directors, but also on the activities of the firm and the performance of privatized companies. However, both SOEs and newly privatized companies have struggled in a hostile environment of weak domestic demand and export markets, non-payment of receivables by existing customers, the need to search for new customers with new products, and reduced availability of bank credit. In this hostile environment, neither SOEs nor newly "internally privatized" companies have fared well financially.

The main successes in effective corporate governance during 1991 - 92 seem to have been the relatively small number of enterprises in Hungary, Czechoslovakia, and Poland that were sold through trade sales to dominant foreign investors; and in the pre-privatizations mode, CSFR management of SOEs by their "founding ministries".

Because of the possible need to "stretch out" the privatization of SOEs over many years, effective interim management by the state is essential. In Czechoslovakia, external corporate governance remains partly with strong founding ministries who maintain a technical knowledge and interest in the business of these enterprises. In the Czech Republic, founding ministries put pressure on the management to perform and solve their operational problems. Management knows that if they fail to perform, the founding ministry can replace existing management by opening tenders to find new owners/managers, putting the company into liquidation, or encouraging competing privatization projects.

In Hungary, the SPA and (now its sister holding company) nominates its agents to the supervisory boards, who do not necessarily have any stake in keeping the enterprise running as a going concern. In Poland, corporate governance responsibility also falls to a supervisory board which is comprised of workers, management, and the government. There is a critical shortage of qualified people to participate on these supervisory boards.

New Dominant Investor

One role of corporate governance is to avoid misappropriation of assets by managers. Hungary's earliest spontaneous privatizations in 1989 and early 1990[1] may have erred in that respect. The relations and lines of decision-making authority between management, workers' councils and the State became less clear. The lack of supervision over the disposal of state assets created a public outcry leading to the creation of special government agencies charged with controlling the privatization process.

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[1] In Hungary, unlike Poland and Czechoslovakia, the process of commercializing state assets began in the last years of the communist regime. In 1987, a number of SOE managers discovered that some precommunist laws on commercial companies, dating back to the 19th century had never been revoked. This allowed for the legal creation of subsidiaries capitalized with a portion of the assets of the SOEs, providing managers the opportunity to divert a portion of state assets to their own control and often, partial ownership.

Dominant foreign investors (not examined as case studies for this report) set a high standard for effective corporate governance. When a domestic investor takes a majority ownership stake, the new management does not have ready access to the external resources and business knowledge possessed by a foreign investor. As a result, the impact of ownership change is less visible. Nonetheless, the changed motivation and drive by such new entrepreneurs is evident, as they are increasingly entering into joint ventures, and licensing and marketing agreements with foreign firms.

Internal Privatization

Initiated mainly by management and workers as distinct from sales or share-offerings to outside investors, internal privatization includes management/employees buy outs, liquidations, ESOPs and "spontaneous" privatizations. Importantly, internal privatizations generally seek to promote dispersed domestic ownership of the privatized entities, with the expectation that the individual owners will become involved in managing the newly privatized business. It has been the method by which the majority of large and medium privatizations have been completed to date. However, to date, survey evidence (Poland) and general opinions (in all 3 countries) do not yet show decisively improved corporate governance and performance of "internally privatized" companies vis-a-vis state managed companies.

Hard Budget Constraints

Under any management regime, hard budget constraints undoubtedly contribute to better "corporate governance". Liquidation and enactment and enforcement of bankruptcy play a vital role to insure the exit of loss-making firms and reduce financial hemorrhaging. Recent World Bank surveys of private sector manufacturing in the three study countries found that among private sector firms, equipment and factory buildings were predominantly bought or leased from current or defunct SOEs. Further, most entrepreneurs had prior experience in SOEs. Most of these new, private sector firms using ex-SOE equipment and buildings were found to be profitable and sound. Hence, SOE human and physical assets do have alternative productive uses, and their release helps to create new employment and income.

The mass privatization programs in the Czech and Slovak Republics and in Poland seek to improve corporate governance, and reduce risk to be borne by individual investors, by shifting supervisory control to financial intermediaries. Until the role of these intermediaries in the governance of enterprises is defined, Czech and Slovak enterprises continue to operate under the direction of their founding ministries, as always. In Poland, the mass privatization program -- now authorized by parliament but not yet implemented -- has been carefully designed to avoid an overly wide dispersion of ownership, to provide incentives for more immediate improvement of management (utilizing foreign investment advisors), and to reduce risk to Polish investors.

Mass Privatization

Mass privatization programs exist primarily in Poland and the Czech and Slovak Republics. There are some 8,500 medium to large-size SOEs in Poland and some 7,000 large-scale ones in the Czech and Slovak Republics. Because of the constraints on sales to foreign investors and the uncertain governance benefits of internal privatizations, mass privatization followed by restructuring is seen as an effective way to accelerate privatization for many of those large firms.

Mass privatization may include the distribution of shares in SOEs to the public, either free or for a minimal charge, usually through a voucher allocation scheme. Several other countries are using voucher schemes in their programs -- for example, Lithuania, Russia, Mongolia, and Romania -- and their use is planned in still others, such as Kazakhstan and Uzbekistan.

In the mass privatization process, the voucher holders directly or, through investment funds, indirectly acquire majority ownership of a predetermined group of enterprises. The enterprises can simultaneously use other approaches to privatization, including : (a) liberal arrangement for management and employee buyouts; (b) transfers to entrepreneurs at book value; (c) leases; (d) more extensive utilization of management contracts and contracting out of these options; and (e) foreign investor participation. Mass privatization schemes promise rapid privatization with widespread involvement of the populace. Not surprisingly, however, these schemes are exceedingly complex, hold many pitfalls, and, if not developed carefully, may delay privatization overall.

The experiences of Czechoslovakia and Poland suggest that the approach to mass privatization should be bottom-up and decentralized so as to gain the widest possible base of support; the program also requires strong leadership from the highest government levels. The Czech and Slovak program proceeded on the basis that the enterprises must be responsible for preparing their own privatization programs, competition should be encouraged by allowing parties beyond existing management to prepare privatization projects, the population should be involved in privatization to the fullest extent possible through voucher distribution, and investment funds can be formed spontaneously and not through government intervention. This was achieved in Czechoslovakia, but the funds have not been operating long enough to determine their competence and financial viability as financial intermediaries. Also, because the Czech and Slovak program puts maximum emphasis on private initiative, it has obtained commitment at all levels and the program itself is functioning. After initial delays, 1872 firms were privatized in the first wave, and another 2,500 are scheduled for privatization in 1993.

Conclusions

The structure of country privatization programs and their implicit objectives have strongly affected the pace of privatizations. Where worker groups, localities, and/or founding ministries have been vested with powers to nominate and approve an SOE for privatization as against a centralized authority, progress in privatization has frequently been blocked. In Poland, incentives to overcome worker opposition have not been very effective. Two such incentives have been elimination of the surtax on wage increases when converting from an SOE to a joint stock company and the opportunity to purchase at a reduced price up to 10% of outstanding shares. These incentives have generally been insufficient to motivate workers to abandon their effective management rights over SOEs through representation in workers councils. Hence first steps toward privatization through creation of a joint stock company and hence direct sale or public offering have been very slow in Poland. Since conversion to a joint stock company is a voluntary process for SOEs in Hungary, such transformations have been slow. Furthermore, maximization of revenue and overemphasis on sales at a price not below book value have contributed to the slow progress by the SPA in Hungary in privatization.

In Czechoslovakia, the more rapid pace of privatization resulted from a combination of factors, notably:

-- the strong hand of the Ministry of Privatization in identifying firms for inclusion in the privatization program;

-- explicitly identifying the SOEs to be privatized and placing them in one of two waves of privatization;

-- the requirement that management prepare a privatization proposal within a given time frame,

-- encouragement to others to prepare competing privatization proposals which resulted in an average of four proposals per SOE (during the first wave management prepared proposals, and further competitive proposals were submitted; in some case as many as 20-30 separate proposals were received for a single SOE);

-- creation of the voucher program, and recognizing that private finance from domestic savings and foreign investment would be insufficient to buy out more than a portion of the SOEs;

-- centralization of decision-making in the Ministry of Privatization as to the method of privatization for the candidate SOEs.

Each of the countries has embarked on very different means to the same end. As the public awareness level rises and there is increasing bottoms-up support for privatization, more countries are becoming more innovative and diverse in the methodologies they use. The structure of methods used for privatization is already changing in relation to how it was very early in the process, and it is clear that they are learning from each other.

In early March 1992, in Czechoslovakia, voucher privatization accounted for almost three quarters of all property approved for privatization, but one year later, it accounted for only 62%. Privatization by direct sale accounts for over 20% of all business units approved for privatization, whereas in March 1992 it accounted for only 9%. These proportions are certain to change even further. Direct sale was the proposed means of at least partial privatization in almost 45% of all projects submitted, including those with foreign joint venture participation. Thus it is fairly certain that the share of enterprises privatized in this manner will increase significantly in the coming months. The share of Czech enterprises transferred to the private sector through public tender or auction is also likely to increase.

This study of the privatization programs of Hungary, Czechoslovakia and Poland showed that while there are common elements, the programs have developed in very different ways with varying results. These differences can be traced to the objectives of each country's privatization program and how various privatization methods were used to meet those objectives. In Czechoslovakia, where the stated objective was simply to privatize quickly, top priority was given to this objective and techniques were developed to ensure that this objective would be met. In Hungary, where the government sought to achieve a number of objectives simultaneously, such as privatizing quickly and maximizing proceeds from the sale of its SOEs, a conflict was created which was resolved by slowing the process.

In Poland, the general desire of the government to privatize was sincere, however, competing objectives for the privatization program quickly emerged among several groups which slowed the process. Workers councils wanted to maintain control, profiting from the new environment and moving to a market economy, reformers control the ministry of privatization while the line ministries are often dominated by conservative elements maintaining the status quo.

Lessons Learned

There are a number of conclusions which have emerged in the privatization processes of these three countries that other countries in Eastern Europe and donor agencies can learn from the host governments and their programs. Broadly, these conclusions relate to both the appropriateness of the measures adopted by the countries and systemic or environmental issues which need to be addressed as a result of embarking on a program of privatization. Host government policymakers must decide about the appropriateness of the programs they have undertaken against the unique conditions in their respective countries. However, whether or not the techniques are useful, there are certain systemic weaknesses or issues which seem to be common throughout Central and Eastern Europe and the former Soviet Union, and will affect the success of the overall privatization process. Donor agencies can provide the expertise to help those policymakers, and the real contribution of international technical assistance programs has been helping the host countries address the systemic issues which impact the success of the overall privatization process.

Appropriateness of the Programs

1. <u>The need for political support.</u> Privatization is an intensely political process requiring top-down commitment at the highest political levels. Failure can rarely be attributed predominantly to technical reasons, but rather in a lack of decisive leadership and in failure to resolve competing objectives. Each program will have several objectives which need to be met, such as equitable distribution, speed of ownership transfer, safeguarding employment and attracting new investment. However, all of these objectives cannot be met simultaneously, so trade-offs must be carefully considered and made.

   The lack of political support and subsequent delay in the Polish mass privatization program caused considerable problems in the overall privatization process. Workers and management were not willing to commit to take any actions until their alternatives were clear. Investors were hesitant to enter into negotiations with companies earmarked for the program. In effect, 600 of the largest and most successful enterprises in Poland were left in limbo while the politicians argued. On a more general basis, lack of political support has caused privatization officials in each of the countries to delay making decisions or to take any responsibility for their actions.

2. <u>One or two internal privatization programs which are simple to implement should be developed.</u> Internal privatization is the most prevalent method among completed privatizations in the three countries for medium and large enterprises, because of the relative ease of the process, the bottom-up participation of management/workers, and the limited number of foreign participants willing to take the risks and complexity of the investment and restructuring process. Because of their limited financial capacity, buyouts by managers may be most appropriate for companies that have relatively few fixed assets.

   In all of these countries the benefits of worker-management buy outs and other internal privatizations are <u>not</u> impressive at this stage. Yet there is still no clear evidence that enterprises privatized internally have performed better than SOEs under hard budget constraints. The issue needs to be further documented before any conclusions are made. Therefore, governments should be wary of schemes that give SOEs away to under-capitalized worker-management groups who lack access to outside technical expertise and finance.

   Although many privatization techniques can be used to meet the objectives of the program, making too many options available at once may slow the process and endanger the program. For example, Poland has developed a variety of programs creating a situation where management/workers and even regional privatization officials are unsure of how to proceed.

3. <u>If the process for tendering companies to dominant investors is competitive, governments should not reject privatization deals just because the offer price is far below book value.</u> Policy makers have been reluctant, in certain instances, to open the process to competitive tendering using book value as a floor price due to a fear of "giving away" the enterprise to

insiders. An essential part of a successful competitive tendering system is ensuring the effective and efficient dissemination of information. Demonstration of an effective marketing campaign can alleviate some of these concerns.

4. <u>Mass privatization is a means to equitably, widely and quickly distribute ownership among the citizenship which fits the unique requirements of East European countries and those of the NIS where ownership is concentrated in the state sector.</u> The Czech and Slovak and Polish programs are potentially important demonstration cases. The approach to mass privatization should be complementary to, rather than replace the other forms of privatization. The Polish and Czech/Slovak mass privatization programs have some significant differences, yet until the Polish program goes into operation it is difficult to assess which is the better example.

Systemic Issues

1. <u>In Central and Eastern Europe, the absence of a legal and regulatory infrastructure, has threatened to derail privatization.</u> All of the privatization programs have had to operate, at least initially, in the absence proper business support structures, including legislative and regulatory frameworks, to allow privatized businesses to operate commercially in a stable environment. Fair and predictable legal systems must be developed, as well as the judicial system to support it. One interesting set of factors has been the problems of land ownership and restitution. The Polish failure to deal with restitution issues on a broad scale means the issue must be resolved for each transaction.

2. <u>All countries embarking on privatization have realized that it must proceed in tandem with reform of the financial sector.</u> The central credit allocation mechanisms and the lack of credit discipline by banks and suppliers of the former socialist system are unsuited to a market economy.

Enterprise credit mechanisms of local commercial banks have been developed to a limited extent in each of the countries. Yet little, if any, financing is available from financial institutions without extremely high levels of collateral, which typically these companies (or their new owners) cannot meet.

Additionally, seoondary markets for equities must be developed alongside the privatization program to allow market forces to operate efficiently and to provide broader access to alternative sources of capital. Regulatory structures must be developed, share registries created and other relevant institutions built.

3. <u>There must be adequate social safety nets to undertake the wide sweeping restructuring and privatization necessary to achieve efficiency in industry.</u> Privatization programs need to take into account the adverse social impact associated with enterprise restructuring, which is likely to lead to large-scale layoffs, sometimes in geographic areas where the enterprise is the main source of employment. The spin-off of non-productive social assets currently supported by all large SOEs in the region is likely to have an adverse social impact. Failure to deal with these issues risks derailing the privatization program, for example the lack of financing for decoupled services and consequent budget pressures in Poland has caused the governments to fall.

   This is an area where donor agencies can usefully assist to help policymakers create fiscally sound and socially responsible programs to fill the void created by the privatization of enterprises which were the traditional providers of social assistance in these countries.

4. <u>The critical shortage of qualified managers and directors can only be addressed through massive education and training efforts.</u> Privatization has generally had little effect on corporate governance in the absence of a dominant (foreign) shareholder even though managers have shown considerable willingness to adapt to their new circumstances. Many managers of state enterprises see their future employment and careers linked to the success

of their enterprise, but they need the business tools in marketing, finance and management control systems. This is a critical area for donor agency assistance.

5. Public information (public relations and mass communications) is vital to educate the public about privatization in general and specific issues such as vouchers and investment funds. There is also a need to link privatization in the public's perception to the overall reform program and the transition to a market economy. Hungary, Poland and CSFR understood this need for public information belatedly and have not had adequate funding to carry out such a program.

6. Liability for environmental problems is a determent to foreign investors and may loom as an even bigger problem for other investors in newly privatized firms, as the local authorities seek to enforce environmental standards. While some major foreign investors may be willing to take on responsibility for past environmental damage, the financial resources of domestic acquirors are unlikely to be sufficient for them prudently to accept such responsibility. In selling businesses, governments will need to recognize that they may have to continue to retain the contingent liability for remedying past environmental damage even if its full effects have not yet come to light.

I. INTRODUCTION

This study is a review of the privatization processes taking place in Central Europe which has been undertaken by the U.S. Agency for International Development to help disseminate the experiences of Hungary, Poland and Czechoslovakia[1] to other countries at an earlier stage in their privatization processes, such as Rumania, Bulgaria, the Baltics and the Newly Independent States (NIS) of the former Soviet Union. The results of the study identify key lessons learned from these processes at the early stages of Central European economic reform during 1990-1992; in addition to dissemination to other countries embarking on privatization programs, these results serve to contribute to the debate on the next phase of privatization in these countries as well as identify some areas for donor agency participation.

The primary research was conducted in October-November 1992 through a series of interviews with the management of both SOEs and newly privatized companies, with relevant investment funds, pertinent government officials and external professionals engaged in the privatization process of Hungary, Poland and Czechoslovakia. We would like to acknowledge the efforts of the field assessment teams of Ira Lieberman (mass privatization), Paul Elicker and Paul Sacks (internal privatization), and David Kochav and Kevin McDonald (corporate governance) for their work in developing the materials for this study. Furthermore, we appreciate the outstanding efforts of our country experts, Michal Mejstrik and Ladislav Venys (CSFR), Janusz Dabrowski and Jan Szomburg of the Gdansk Institute for Market Economics, and Jay Madigan (Poland), and Peter Kurz (Hungary) in providing valuable guidance, and secondary resource materials, and gaining access to top officials and managers for constructive host country meetings. Finally, we acknowledge the research work of Michael Ratliffe in providing us with the most current information available on the new Hungarian State Asset Holding company.

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[1] As of January 1, 1993 Czechoslovakia separated into two separate states representing the Czech and Slovak republics. This paper primarily utilizes the term Czech and Slovak republics to designate these two states, however, from time to time it utilizes CSFR (Czech and Slovak Federal Republic) or Czechoslovakia, appropriate names prior to separation.

This report presents an analysis of the findings of the field assessment teams with respect to the role of effective corporate governance in the privatization process and the design and implementation of the internal privatization and mass privatization programs. Generally, the experiences to-date support the conclusion that the privatization of state owned assets must occur alongside other vital reforms in order to create a market economy where none has existed for more than 40 years.

The findings also indicate that after many delays and setbacks, privatization in Hungary, Poland and Czechoslovakia is experiencing some success. The process itself is gaining support even though the underlying infrastructure needs further development to ensure the stability of the newly privatized enterprises. The following section sets out the environment for privatization in these three countries in order to show why the programs have developed differently.

II. THE POLITICAL, LEGAL AND ECONOMIC FRAMEWORK FOR PRIVATIZATION

Background

The legacy of centrally planned economies in Hungary, Poland and Czechoslovakia dictated completely different conditions for privatization process from that existing in other countries which had undertaken privatization, such as the United Kingdom, Jamaica or chile. the public sector in Eastern Europe represented anything from two-thirds to nine-tenths of all productive economic activity. Despite persistent reform efforts that were fragmentally enacted from the 1960s onwards, SOEs in the ex-communist economies of Hungary and Poland never achieved the efficiency and productivity expected of them, and their performance deteriorated sharply in the period 1970-1989. The accompanying stagnation in the economy accentuated the need for the political changes that occurred in 1989-90, and provided general support for privatization among the population.

Immediately following the political changes in the period 1989-91, Hungary, Czechoslovakia and Poland experienced bouts of high inflation (hyperinflation in the case of Poland), decreases in industrial production, and increases in long-term external debts (see Table 1). In order to address the macroeconomic problems threatening to undo the new political freedom in these countries, numerous actions were undertaken with great speed, such as introducing tight monetary and fiscal policies, devaluing currencies, instituting hard budget constraints while liberalizing prices, and developing privatization initiatives to divest state assets. Economic "shock therapy" based on very tight monetary policy was introduced in Poland in early 1990 as the best means for realigning the major macroeconomic elements and creating a base for market economics. However, the ensuing human costs and social strain in Poland caused Czechoslovakia and Hungary to pursue other, less dramatic courses. During this period high level Polish officials publicly supported the decision of the other two governments and openly counselled them to avoid their course.

The economic indicators for 1991 showed the continuation of disturbingly high recession figures (a decline in industrial output ranging from some 25 percent in Czechoslovakia to 12 percent in Poland), which caused alarm among the politicians and wariness among foreign investors. In 1992, however, these figures began to show improvement. In the case of Poland, where industrial output dropped by only 3 percent in 1992, government officials believe this was due to a substantial rise in private sector output that offset the consequences of the continuing recession in the public sector. It may have been more than a coincidence that Polish agricultural and construction sectors, two areas of the economy dominated by the private sector, were the branches least affected by a drop in production.

Table 1 - Economic Indicators

	Hungary	CSFR	Poland
Real GDP (% change)			
1988	-0.2	2.5	4.1
1989	-0.2	1.4	0.2
1990	-4.3	- 3.1	-11.6
1991	-7.7*	-15.9	- 7.2
1992(1)	1.8	- 5.0	- 1.0
Industrial Prod. (% change)*			
1988	16.0	na	na
1989	na	na	na
1990	- 9.6	- 3.7	-24.2
1991	-19.1	-24.7	-11.9
1992(1)	-16.6	-21.4	- 3.0
Consumer Prices (% change)			
1988	14.8	0.6	60.2
1989	18.9	1.5	251.1
1990	33.4	10.8	585.8
1991	35.0*	58.7	70.3
1992(1)	24.2*	11.8*	47.0

(*) Source: CESTAT Bulletin, 92/93.
(1) 12-month period ending June 1992.
Source: IMF, or as indicated

The 12 percent drop in industrial output in Poland in 1991, and the higher drops in output in Hungary and Czechoslovakia in 1992, were of more concern to analysts and government officials than those of the preceding years because, although the drops in output one year earlier were higher, it was believed that this was a market cleansing of uncompetitive products poorly manufactured at very high prices. The reasons for decline in the following year were more complex than the uncompetitiveness of these industries. The collapse of the Soviet market as well as the rest of COMECON had considerable impact on the depth of the central European recession. Equally significant were macroeconomic policies aimed at checking inflation through tough monetary measures, and the low competitiveness of domestic products in the face of foreign imports. Finally, the recession in the industrialized nations made it difficult to find new markets in the West or to convince foreign investors to take on the risk and expense of investing directly in Central Europe.

An examination of the state budgets at the end of 1991 showed to varying degrees, a deterioration in the profits of the enterprises. Hungary, Poland, the Czech Republic and Slovakia and posted losses in the state section. In the case of the Czech and Slovak Republics, inter-enterprise debt of state-owned companies indicated that real performance of the enterprises was worse than the official statistics showed; inter-enterprise debt nearly quadrupled in one year from Kcs 46.8 billion ($1.2 billion) at the end of 1990 to Kcs 170 billion ($5.7 billion) in 1991. In Hungary, despite dropping subsidies to enterprises from 13% in 1989 to 7% in 1991, the state sector deficit hit an unexpected high of $1.5 billion due to the lower than expected tax revenues; inter-enterprise debt was estimated at slightly less than $4 billion.

The situation was more serious in Poland, where due to the poor performance of most enterprises and increasing inter-enterprise debts, corporate tax revenues and "dividends" from the SOEs fell short of target. Additionally, the proceeds from the sale of state assets were far less than anticipated. The deterioration in the performance of the region's enterprises created the financial, economic and political imperative to privatize quickly.

The Role of Privatization in Economic Reform

Privatization has been viewed as a principal mechanism to transform society from communism to capitalism. Its overriding purpose is to transfer property rights to private owners who have personal incentives to protect their interests and who will support the move to a free market economy through their actions and through their votes. For the transition to succeed private owners will need both economic and political influence, which creates the need for privatization on a large scale. In this context, privatization not only attempts to put previously under utilized or wasted resources to more productive use, it also plays a major role in the transformation of these societies.

Table 2 shows the extent of privatization in these economies, with the results categorized by the methods of privatization used in these countries.

Table 2 - Privatized SEOs (as at June 1991)

Country	Total No. SOEs	Internal Privats.	Mass Privats.	Book Value
Hungary	2000	40	-	572 bn FT ($8.1 bn)
Czech Republic	3908	2259	1649	501.6 bn Kcs ($16.97 bn)
Poland	8500	54		$0.375 bn
Totals:	17500	94	1743	$28.775 bn

Some of the date on the number of wholly privatized companies is inconclusive because of the new emphasis on privatizing "business units," which are pieces of SOEs spun-off to create new business. While the real number of SOEs privatized to-date may be small in comparison with the goals of the governments. It is clear that the private sector is growing rapidly in these countries. For example, the number of registered private firms in Hungary grew from 5,000 in 1989 to 58,000 by the end of 1991; private sector revenue in early 1992 accounted for more than 30 percent of Hungary's GDP. Equally impressive private sectors have emerged in Czechoslovakia, where the privatization of small-scale enterprises (shops, restaurants, etc.) was successfully completed in 1991 with some 21,000 units sold (for proceeds of $860 million), and in Poland where the private industry increased its output by 25 percent in the same year that output from SOEs plummeted 20 percent (1991).

Foreign Direct Investment

In the 12-month period ending September 1992, joint ventures and direct foreign investment rose dramatically. Of these deals, 138 represented acquisitions, 60 were joint ventures and 67 were grainfield investments. foreign investment in Poland during this period represented 15% of the total foreign investment in the twenty-eight states of Central/Eastern Europe and the CIS. U.S. investment included 21 deals ($454.6 mn) in the Czech and Slovak republics, 29 deals ($1.5 bn) in Poland and 39 deals ($640 mn) in Hungary. In 1992. the U.S. was the highest investor in Central Europe, passing even Germany.

Table 3 - direct Foreign Investment (Cum.)

	1990	1991	1992	1993 Proj.
Czech Republic	NA	NA	500 million	1.6 billion
Hungary	1.2 billion	3 billion	4.3 billion	NA
Poland	640 million	700 million	2.5 billion	NA

NA = not available

Source: US Department of Commerce

Table 4 - Foreign Investment Activity in Eastern Europe
(for year ending September 30, 1992)

	Number of deals*	Disclosed value ($ millions)
CSFR**	55	1437
Czech Republic	56	804
Hungary	171	1492
Poland	61	4158
Slovakia	13	126

* Includes acquisitions, joint ventures, grainfield investments.

** Includes deals which involved both the Czech Republic and Slovakia.

Source: East European Investment Magazine, December 1992.

The Politics of Privatization

While the collapse of communism and of the state control over the ownership of the socialist enterprises in Eastern Europe during the late 1980s led naturally toward a process of decentralization of decision making by the state ministries, one could not necessarily have predicted that this would result in privatization simply in order to change the ownership of state enterprises: it usually seeks to achieve a variety of other objectives as well, such as providing evidence of a political commitment to reform, displacing the nomenclature, and restructuring non-productive state assets. In addition, the methods of privatization themselves inevitably raise political questions.

In all three countries the progress of privatization has been influenced by the way in which the communist regime came to an end. In Poland, for example, the role of the trade unions in the revolution has led to much greater worker control (through Workers' councils) over the privatization process and a greater emphasis on employee ownership than has occurred in either Hungary or the CSFR. Political desire in some cases to reverse economic measures of the previous regime has led to the adoption of policies which constrain the process of privatization. For example, there is no doubt that privatization in the CSFR has been slowed down and complicated, particularly in cases of businesses with substantial real estate, by the policy of restitution. suspicion of those who rose to head enterprises under the previous regime has also affected the smoothness of the privatization process. While the simplest method of privatization is often to sell the business to the existing management, in all three countries that kind of sale is often to sell the business to the existing management , in all three countries that kind of sale not initially encouraged. Indeed it has sometimes been rendered impossible when top management has been removed from office as a result of "lustration" laws (e.g. laws which ban classes of individuals, such as former communists, from holding state office regardless of professional ability or of proved guilt of specific offenses).

During interviews conducted in the field assessments, the politics of privatization was cited most often as the largest barrier to the privatization process. This is discussed more thoroughly in the sections below, as it applies to the various methods of privatization as well as corporate governance.

Creating the Legal and Regulatory Framework for Privatization and Private Sector Development

As Hungary, Czechoslovakia and Poland began their transformations to market-oriented economies and the privatization of their state-owned sectors, reform of the legal and regulatory environment was imperative, and the process began almost immediately.

In Eastern Europe, the process of establishing the legal and regulatory framework for the creation of decentralized market economies has occurred simultaneously with the process of privatizations.

Unlike other countries with a tradition of private enterprise that have embarked on wide-scale privatizations (e.g., New Zealand, Mexico, Indonesia and Chile), Hungary, Czechoslovakia and Poland have had to create new foundations for market economy. Financial and capital markets were not simply underdeveloped, they did not exist. Managers were not just poorly trained and unmotivated, they had to be re-engineered. Managers in the state-owned enterprises had a very limited authorized decision-making process; they were responsible only for satisfying targets and plans imposed from above.

The lack of an independent judiciary and independent financial institutions, of contract law and enforceable contracts, and the absence of market mechanisms for more than forty years created a high-risk environment for the development and operation of private enterprises.

As new private enterprises have emerged and initial privatization of state enterprises have occurred, the drafting of laws and regulation has often been a reactive process. Laws have been drafted and enacted as the need was identified, without due consideration for the necessary sequencing of those laws. Thus, one of the first pieces of legislation to be drafted in each of the countries was a generic "privatization act" authorizing governments to transform or sell state assets. This was accompanied or followed by legislation empowering managers to make investment and acquisition decisions, and to enter into negotiations with foreign entities without need of recourse to the Central Government. Usually, but not always, such legislation was preceded by the promulgation of foreign investment codes.

Unfortunately, this fundamentally reactive process led to certain important pieces of enabling legislation being neglected, and the absence of such legislation has seriously affected the creation of an environment conducive to private sector development. In Poland, the absence of a functioning bankruptcy act has made it an extremely difficult and cumbersome task to liquidate SOEs and to assist troubled enterprises in reorganizing their entities. This has complicated the imposition of a hard-budget constraint (i.e. no more state subsidies to loss-making SOEs) and has distorted economic incentives and market conditions. Struggling and often non-variable enterprises continue to exist and make claims on scarce budgetary resources. Such claims are accommodated, in part, due to concerns over unemployment and redundancies, and in part due to the social services they provide to their communities.

An appendix to this section lists the legal and regulatory environment which was created for commercialization and privatization in each of the countries.

III. CORPORATE GOVERNANCE

Introduction

The laws on transformation and commercialization of state-owned enterprises created new corporate governance structures for the converted enterprises. This section examines the ways in which privatization has affected corporate governance of both privatized and non-privatized enterprises, and the extent to which the lack of pre-privatization governance structures and the need for control and supervision led to abuses in the privatization process and the creation of new bureaucracies.

The initial expectation in Central and Eastern Europe was that privatization would have a dramatic, positive effect on corporate governance, not only on the structures of management, such as the creation of boards of directors, but also on the activities of the firm and the performance of privatized companies. The drastically changed environment, however, threw enterprises into a state of shock as domestic demand dropped, export markets collapsed and access to working capital dwindled; enterprise management faced the need to quickly reorganize operations, improve product quality to increase exports to hard currency markets, and reduce product costs in order to compete with imported products in the domestic market. In addition to the internal concerns of the enterprise, management [illegible]ed suddenly into the marketplace in search of both customers and finance. The nee[illegible]anagement skills, financial resources, as well as basic infrastructure far exceeded the countries' capabilities to respond, and the majority of state-owned enterprises floundered, creating an increasing financial drain on the national treasuries and a political imperative for privatization.

The earliest spontaneous privatizations in 1989 and early 1990,[1] occurred without appropriate corporate governance arrangements. Likewise, corporate governance regimes for the new private enterprises and arrangements for the SOEs remaining in the public sector indefinitely had not been developed. The relations and lines of decision-making authority among management, workers' councils and the State became less and less clear, and the lack of supervision over the disposal of state assets created a public outcry and led to the creation of special government agencies charged with controlling the privatization process.

As the process of privatization began to take shape, new corporate governance structures were created as part of the legal requirement to privatize the state enterprises. However, the process has not been able to create either the cadre of managers or a functioning decision-making hierarchy at an enterprise level to help these enterprises stabilize and recalibrate to their new and difficult environments. Through the interviews conducted for the present report it became apparent that the most dramatic changes in corporate governance of enterprises has occurred in a small number of trade sales involving dominant foreign investors, but little real change has occurred in the effective management of enterprises in these countries despite changes in the corporate governance structure.

However, not enough time has passed to assess the real effects. In the Czech Republic particularly, where responsibility was thrust upon management to design their own privatization plans (discussed more fully below), the process of creating these plans helped management clarify their approach to management structure, improved operational efficiency and marketing. Some managers dramatically increased their sales to the West to levels almost equaling previous sales to the former Soviet Union. In Poland, where the privatization process was slow, managers have begun to realize that their personal futures are linked directly to the success of their enterprises, and are anxious to improve performance in

[1] In Hungary, unlike Poland and Czechoslovakia, the process of commercializing state assets began in the last years of the communist regime. In 1987, a number of SOE managers discovered that some precommunist laws on commercial companies, dating back to the 19th century had never been revoked. This allowed for the legal creation of subsidiaries capitalized with a portion of the assets of the SOEs, providing managers the opportunity to divert a portion of state assets to their own control and often, partial ownership.

anticipation of privatization. They are limited, however, by vast training needs and an acute shortage of working capital.

The Move from SOE to Private Company

Changes in the corporate governance structure have taken place in two stages: a) at commercialization, and b) at privatization. Commercialization, corporatization and transformation are analogous terms used in the region to denote the conversion of an SOE to a joint stock company, where ownership continues to be held by the state but governance is transferred to the enterprise level. At commercialization the State appoints a supervisory board in consultation with the relevant branch ministry. Generally, commercialized companies have very few, if any, outside directors not representing the ministries or the agency representing the State. From the interviews, it was noted that the supervisory boards were either passive or ignored by management, and that the companies would have benefitted if the supervisory boards had more outside members with some business experience.

Early problems with spontaneous privatizations, particularly in Hungary, led to the perceived need to control the disposal of state assets more carefully and create this intermediate step between state control of the assets and private ownership. The process, while well-conceived, has not met with great success, and the impact on governance has been minimal.

Hungary's process of transformation was a series of half-steps, based first in the Company Law of 1988 and later in the Transformation Law of 1989. The Company Law firmly legitimized the commercialization of portions of SOEs begun in 1987, which allowed management to transform their SOEs into shells for the new companies created out of the SOE's assets. While the shells continued to be subject to the Law on Enterprise Councils (1984), which guaranteed workers' participation in the management of "self-managed" enterprises[2], the shells were often left with few employees (the others having been transferred to the new company), thus leaving the management firmly in control of the voting stock of the new downstream companies. Additionally, the liabilities of the SOE did not transfer to the newly commercialized companies, opening new credit possibilities for these companies. The Transformation Law permitted the conversion of whole companies, rather than portions of the assets, with the state becoming owner of those shares not sold to insiders or other investors, which often were other SOEs. Under this law, which attempted to eliminate some of the abuses possible under the Company Law, the old SOE disappeared when the new corporate form was created, and the liabilities of the SOE transferred to the new company. The major incentive to undergo this voluntary transformation process was the ability of enterprise insiders to acquire 20% of the shares in the new company at a discount of up to 90%. This led to new abuses in undervaluing the assets of many of these enterprises and paying for the insiders' shares with special bonuses voted for the insiders by the insiders' enterprise councils just prior to transformation. These types of abuses, which occurred largely because of inadequate governance, led to a political crisis in Hungary over privatization which greatly delayed the entire process, and created the State Property Agency in March 1990 (discussed below). There is no consistent data regarding the transformation of state enterprises into corporate forms prior to establishing the SPA, however, information provided by the Ministry of Industry and Trade suggests that, by the end of 1989, nearly 10% of the book value of the Hungarian state sector had been commercialized.

In Poland, the workers' councils and general workers' assemblies had played a major role in the enterprise governance system dating back to September 1981 when Solidarity secured the

[2] The Law on Enterprise Councils divided the governance of Hungary's state enterprises into three categories: those under direct state supervision, such as utilities and other strategically important enterprises (approximately one-third of all the SOEs); small SOEs (up to 500 employees) were governed by a council elected by the SOE's employees; in all other medium and large SOEs, the state was represented by "enterprise councils," with 50% of the council membership elected by the workers, 33% coming from management, one person appointed by the ministry, and the rest designated by the managing director. Despite the outward appearance of strong worker participation in enterprise governance under this law, they exerted only minor influence on key decision-making. SOE managers retained most of the control, which allowed them the authority to transform the enterprises later.

legal guarantee for worker participation in the management of SOEs. This insider group has proven to have tremendous impact on not only the privatization process, which one might expect, but also on the transformation process. The law on Privatization of State-Owned Enterprises (1990) provided for the transformation of SOEs into joint stock and limited liability companies held by the state prior to privatization, as well as for liquidation of SOEs and the sale of their assets. This Privatization Law, however, did not find great support in the Parliament and included so many compromises[3], that by early 1992, only 407 SOEs representing 5.3% of the Polish state sector had been converted; 139 of the 407 had been transformed in preparation for the mass privatization program.

Czechoslovak SOEs in 1989, unlike SOEs in either Poland or Hungary where powerful insiders had emerged, were managed tightly from an administrative center in the government. This helped the post-communist government in Czechoslovakia to proceed more rapidly with some of its SOE reforms, with a greater degree of cooperation among the constituent parts of the public sector, than in either Hungary or Poland. The 1990 Law on State Enterprises changed the legal structure of the Czechoslovak SOEs, creating an intermediary form to divest increased decision-making authority to the enterprise in anticipation of privatization. Although the SOE is granted far more managerial authority and is expected to prepare its own privatization plan, the state preserved its ownership rights and control by retaining final approval authority in respect of the privatization plan. The main intention on Czechoslovakia's corporatization program was to give the SOEs greater financial independence and more control of their own disposable profit under continued state ownership. The plan had two steps. First, the SOE was converted into a "state enterprise" with a governance structure giving effective control to the founding organ (usually the responsible sectoral ministry). Next, the state enterprise was converted into a state-owned

[3] The Privatization Law of 1990 created the Ministry of Ownership Transformations (also known as the Ministry of Privatization), but also gave the employees a virtual veto power over the decision to commercialize. As an inducement for the insiders to cooperate with the government's desire to establish a central privatization framework, the law also provided that up to 20% of the shares of each company could be purchased by workers and management at a 50% discount off the issue price, with the total value of the discount capped at the total wage bill during the previous year.

joint stock company under Act No. 104/1990, "On Joint Stock Companies." The program was abandoned as too cumbersome after it had been applied to approximately 100 enterprises. The new approach converts the enterprise into a joint stock company only in preparation for at least partial privatization and where the National Property Fund is expected to exercise corporate governance.

In the next stage when a company is privatized, the new shareholders then appoint a Board of Directors (BOD). In the companies privatized by MBOs, the BODs consist of active managers; usually no outside directors were appointed. In these companies, there appeared to be no significant changes in the key management positions in the new companies, although there was some change to the organization charts as senior management teams attempted to organize themselves to meet the demands of the new environment they faced (ie., creating positions responsible for finance as well as marketing and sales). In all three countries, insiders remain the core of management teams, and the power of management seemed to have increased starting at the transformation stage. Interestingly, in Poland, the power of the workers diminishes partially because the workers' council are disbanded once the majority of ownership is in private hands and because the workers' representatives on the supervisory boards tend to identify with the other ministry-appointed members.

Most key managers interviewed knew what needed to be done if their enterprises were to survive long enough to be privatized, and these priorities were the same among managers of privatized companies. Both groups considered penetration into hard currency markets a major goal, and changing the function of management to be competitive was a top priority. They sought to upgrade product quality and design, engage in pro-active marketing, create financial management systems and increase profitability. Most of the companies visited were trying to undertake these tasks with the tools available to them: enthusiasm and good intentions. Lacking the training and experience to accomplish these business functions, the managers and their teams in companies transformed through domestic ownership structures were far less advanced commercially than their joint venture counterparts.

Improved Corporate Governance

In the cases reviewed during the field investigations, it appears that corporate governance improved significantly only when an enterprise acquired a dominant foreign shareholder, otherwise privatization had little effect on corporate governance. This seems important for countries such as Poland, where investment by dominant shareholders has been impeded by the government's privatization program, in as much as such investments are easily derailed by any involved party and are inadequately supported by the government.

In Hungary and the CSFR, similar conclusions were drawn. Privatized companies which showed an improvement after privatization attributed the gains to the presence of a dominant shareholder. Therefore, it is not privatization per se which led to improved governance, but rather, it is privatization with a dominant, usually foreign, shareholder that made the difference. This observation was supported by both government officials and privatization specialists. The findings of this study suggest that in the absence of a dominant shareholder, privatization is only a first step toward improving corporate governance.

The Role of Foreign Investors as Dominant Shareholders

Direct foreign investors have generally entered the markets of Poland, Hungary and the CSFR through trade sales (sales to single corporate buyers), and have affected a relatively small number of medium to large SOEs. However, in those companies privatized through trade sales to foreign investors, the results have been dramatic.

For example, in Poland, the Thomson-Polkolor joint venture has turned an insolvent Warsaw manufacturer of picture tubes for televisions into Thomson's sole provider worldwide of picture tube masks, the most difficult manufacturing part in the picture tube -- in 16 months. Sales have doubled; production has nearly doubled; western exports have increased from 0% to 60% of output. Moreover, Polkolor had a defective rate of one out of every three glass pieces produced before the joint venture; 16 months later, this rate dropped to approximately one out of two hundred, which is lower than Thompson in Europe, the US and South America, and is comparable to quality rates in Japan and Korea. By introducing new technology, Thomson has helped the Polish enterprise leapfrog over 15 years of technological development that took place in the West, and become competitive in just two short years.

Much of the credit for the success of this venture has been attributed to Thomson's willingness (and stubbornness) to succeed in the face of unforeseen difficulties with both the government and the Polish Development Bank. A united effort between the joint venture partners helped the enterprise make difficult decisions concerning staffing and utilization of other resources, which allowed the enterprise to continue operating. Furthermore, Thomson demonstrated its commitment to the venture by not only introducing new technology, but also by installing eight Western Polish-speaking managers among the top 12 management positions, raising salaries, and acknowledging worker achievements.

The progress of this venture has exceeded greatly Thomson's expectations. The JV was generating a large profit as reflected by the JV's tax liability of $10 million in 1992, a dramatic turnaround from the results of posted by the former state enterprise which never paid a profits tax. As a result, Thomson has decided to increase its initially planned investment of $35 million and put in a total of $100 million over the next three years. The company also plans to increase employment by another 600 workers in the next year, as sales continue to grow.

The success at Polkolor was due to the strong direction and support provided by its dominant foreign shareholder. In sharp contrast, MMG, an internationally competitive and profitable Hungarian company is an enterprise which has been made worse through the process of privatization; the enterprise lost its governance system, and then fell victim to a lack of clear decision-making, an unmotivated privatization advisor, and a self-interested government agency, with little real hope for survival.

A few years ago, MMG, a producer of miscellaneous process controls, switches, instruments and appliances, was one of the largest 100 companies in Hungary and was highly profitable. The company's main activity was producing controls and valves for oil wells and pipelines in the Soviet Union; with the collapse of the COMECON, MMG lost most of its business to Western companies affiliated with the Western drilling companies making inroads into the former Soviet Union. MMG operated in a German joint venture to supply both Festo and Honeywell with components. By all accounts, MMG should have been a prime target for foreign investment; instead, MMG sold a building in 1991, experienced an extraordinary gain and thus avoided posting a loss, but in 1992, was expecting a loss.

In January 1992, the company was commercialized as a pre-cursor to privatization. The effect was to replace the a well-functioning and internally supported enterprise council, composed of management and employees in equal proportion with two governing bodies: a supervisory board and a management board. In each case, the proportional majority of seats on these boards was held by outsiders to the company appointed by the SPA.

An international advisor was appointed to privatize MMG and find an international investor. After six months and sending prospectuses to 140 international companies, the advisor was able to generate only one or two leads with no closure, and the advisor withdrew. It was felt by the management of MMG that by accepting the assignment on a pure success fee basis with no retainer to cover upfront costs, the advisor was not adequately motivated to devote the necessary time and attention to preparing the foundation of this transaction.

The management of MMG blames this failure to several factors beyond the financial arrangements between the SPA and the advisor:

- there was little communication between MMG management and the advisor; the advisor consulted closely with the SPA as the ultimate decision-maker, but the SPA knew little about the company;

- little attention was paid to targeting the most likely prospective investors, and prospectuses were generally mailed to the wrong departments of the companies that were identified;

- the advisor tried mainly to sell the company as a whole. Even though the prospectus stated that portions of the company were saleable as well, the prospectus provided little data about the individual units within MMG.

The advisors claim that they worked under the direction of the SPA, but that the SPA was unable to truly direct the process due to unclear objectives and competing interests within the SPA itself.

MMG has since tried to spin off secondary divisions in an effort to sustain the core business, but the SPA has blocked this plan in favor of waiting for a buyer for the whole organization. In this case, the interest of the governing body is different from that of the enterprise, and the SPA, by virtue of its mandate, has no vested interest in the enterprise beyond maximizing its sales price. Since MMG's new governance structure is linked heavily to the SPA, MMG is unlikely to find support of its ideas at the board levels.

MMG believes it can sell the ancillary operations which are tied to supplying Western and Japanese OEMs, but MMG cannot find their own investors since they do not have the skills to even disaggregate the financial records for these units. Furthermore, since MMG is no longer profitable, it does not have the resources to hire the requisite expertise to create the necessary materials on these companies. As such MMG is convinced that a meaningful dialogue between MMG and potential investors is unlikely to occur and privatization of the company will be equally difficult.

The contrast of these two examples, MMG and Thomson-Polkolor, illustrates the impact of corporate governance in the privatization process, and the advantage for corporate governance by dominant shareholder whose vision and direction are followed by management.

Roles of Enterprise Managers in the Privatization Process

The most critical component of the Czechoslovak privatization program has been the speedy transfer of enterprises from State to private ownership,[4] and the enterprise managers have played a key role. Altogether there are some 4,000 SOEs in CSFR of which about 30 percent will not be privatized in the medium term, either because they are public utilities (such as railways, post office, power utilities) or because it is considered impossible to privatize some very large mining or steel enterprises. In order to privatize thousands of SOEs or their spin-offs the Government decided on a decentralized process by which the Ministry of Privatization directed the process but all enterprises slated for privatization prepared their own "basic privatization projects." These projects had to be prepared by the enterprises' managers; in the larger enterprises this was done with the assistance of domestic or foreign consulting firms.

In contrast to SOEs in Hungary and Poland,[5] workers' councils have not played an important role in preparation of privatization projects in CFSR, although managers have discussed their proposals with workers' representatives. The "privatization projects" have to be submitted to the founding branch ministries for review, following which the projects and the comments of the branch ministry are passed up to the central Ministry of Privatization[6], which is authorized to decide on the privatization method to be utilized.

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[4] In contrast to Poland and to some extent also Hungary, the Government of CSFR initially stated its policy to be not "to reorganize or financially restructure enterprises prior to their privatization, because such tasks are beyond the Government's capacity." (Memorandum of Development Policy - World Bank, Proposed Structural Adjustment Loan, June 7, 1991, Annex II., para. 34.) Nevertheless, by the end of 1991, the Government had changed its stated position and decided to cover some of the debts of enterprises - the "permanent working capital" loans - before privatization, and to recapitalize the commercial banks by issuing obligations of the FNP for CSK 50 billion. The SOEs were not otherwise reorganized or restructured.

[5] In Poland, the long anticipated joint venture between Fiat and the Polish auto-maker FSM nearly dissolved as FSM's workers' council demanded wage equalization with their counterparts in Italy.

[6] In the case of privatization projects in the Czech and Slovak Republics, projects are presented for final review to the Circle of Economic Ministers, which includes the Ministry of Finance.

The preparation of the privatization projects by the enterprises' managers in the CSFR was thought to be extremely useful, since they contained insightful analysis of an enterprise's strengths and weaknesses, and proposed strategy for its restructuring and future operations. On an individual basis, many of the privatization projects were criticized as being weak and inadequate, but this may have been due largely to the managers' inexperience with business planning and preparing management and financial information, rather than as an attempt to undermine the process, as was reported in the local press. The quality of submitted projects improved dramatically in the second wave, demonstrating the benefit of experience and information dissemination over time.

The better projects of the first wave, generally prepared by consulting firms, included analyses of output, capacity, technology, managerial and work force potential. Some of the better projects also contained programs for reorganization of the enterprise, such as splitting it up into divisions according to their activities and potential, together with proposed methods of privatization of the different divisions (including, for some divisions, participation of a foreign strategic partner), and an outline of a business plan.

An additional important benefit of the process of preparation of the privatization projects was the need for the managers to clarify their positions with respect to reorganization and the privatization method of the SOE. In two of the SOEs visited in the Czech Republic - Poldi and Prefa Praha - there was a major controversy between the senior managers who were opposed to a far-reaching reorganization, which would include splitting up and separate privatizations of some divisions, and other managers, including the managers of the various plants, who supported radical changes. The controversy led to major changes in corporate governance, since the managers who opposed major changes were ousted during the commercialization and were not appointed to be managers in the respective new companies.

Governance from Outside the Enterprise

In each of the three countries, government bodies were created to ensure proper supervision of the privatization processes following some of earlier problems and subsequent public reaction. These bodies, the SPA in Hungary, the Ministry of Privatization in the Czech and Slovak Republics and the Ministry of Privatization in Poland, hold the state interests in the newly formed joint stock and limited liability companies, and have taken over the decision-making responsibility for selling the state assets. In the case of the Czech and Slovak Republics, decisions made by the MOP are then implemented by their Funds for National Property.

In Hungary, SOEs are privatized in one of two ways: trade sales or initial public offerings (IPOs). The objective of the SPA is like that of the German Treuhandanstalt, to act as a sales agents for the state owned enterprises, not to restructure or manage the assets. The SPA's parliamentary mandate sets a sales target for the agency of 50% of the companies in its portfolio by 1994, and its performance is measured by its revenues. This, in conjunction with the Hungarian public's sensitivity to the sales prices of these enterprises has meant far fewer enterprises have been sold, keeping them in limbo.[7] In other cases, managing directors of SOEs have criticized the government heavily for doing nothing to attract potential buyers, except to run an advertisement or two in the business press; in contrast, the Treuhand established sales offices in key international business centers such as New York, and prepared information on East German companies for dissemination to prospective investors. Finally, some enterprises with willing buyers complain that they have been waiting more than 18 months to have their transactions approved. Enterprises caught in this void may have to wait and watch their businesses deteriorate further while they wait for the SPA to consider their proposals.

[7] In a recent interview, Dr. Erzsebet Lukacs (SPA) cited the need for a policy in the event that the SPA fails to sell a company. Currently, if the SPA fails twice to privatize a company, the SPA must act as the owners. Then the SPA tells the managing director to try to sell the company himself. In these circumstances, the SPA has a difficult time balancing its fiduciary responsibility as owner/seller with its mandate to sell these companies.

It appears that when large newly established government organizations take over the responsibility for management of enterprises, there is a long period of waiting for decisions, and corporate governance becomes non-functional at this point. In the case of Czechoslovakia, once the enterprises' projects have been approved in the large privatization process, the assets and liabilities are transferred to the National Property Fund (NPF), where the appropriate form of company is established (joint stock, limited liability, etc.). The NPF is then charged with preparing the enterprise for privatization, and may hold the shares for up to five years as the enterprise goes through voucher auctions and the subsequent sale of any remaining shares after the auction. In the interim, the NPF act as shareholders, appointing the first supervisory board and board of directors, and subsequently participating as owners. The policy is to "privatize not administer" the holdings, which implies an extended period of weak governance and little outside control over insider activity; the NPF has, however, taken an interest in the performance of these companies and management itself, motivated by self-interest, is working to improve enterprise performance.

In October 1992, the Hungarian government established the Hungarian State Asset Holding Company ("AV Rt.") to restructure, manage, privatize, and in some instances hold a percentage of the shares because the SPA had been unable to meet its sales targets. The AV Rt. has taken over the management of the government's interests in 163 enterprises, representing approximately 50% of Hungarian GDP. In the absence of a regulatory framework for the governance of these enterprises, the AV Rt. plans to supervise the managers of these companies and try to promote financial and operational restructuring. Optimists feel this is an important step forward for Hungarian privatization because it recognizes the need to not only sell assets, but also manage them. Critics feel that the creation of yet another bureaucracy will only delay the process further; the managing director of the AV Rt. has agreed to manage this 3 trillion forint portfolio with only 80 people until the AV Rt. raises sufficient revenues to support a larger staff.

Current Barriers to Privatization of SOEs

The most frequently cited barrier to privatization is politics. Company managers assert that the process is overly politicized and is blocked by bureaucrats afraid of making mistakes. One member of the Polish Council of Ministers felt that privatization "is the biggest failure of the government in three years. Why did we fail? Politics."

Civil servants more often blame the legal infrastructure [8] and, in the case of internal privatization, the lack of local capital. Foreign investors blame the bureaucracy. Despite the desire to attract at least modest amounts of foreign direct investment, the process is lengthy and cumbersome. Foreign investors must negotiate with the enterprise's management, then with the Privatization Ministry and its foreign advisors. In large acquisitions they also require approval from other relevant government ministries; in Hungary the SPA tends to set limits on foreign participation making it difficult to acquire 51% of the shares in an enterprise. The process takes a long time in many cases because of the need to evaluate several competing proposals not only on the basis of price, but also on the basis of proposed strategy, employment effects and environmental liabilities. More importantly, the process is lengthy because of the need to build political consensus in a frequently changing political and bureaucratic environment.

Differences of opinion among the various ministries and lack of visible guidelines have caused lengthy delays which often undermined political objectives for speedy privatization. In the case of SSZ (CSFR), negotiations lasted a year until an agreement was signed. SSZ was one of the first First Wave transactions to close; despite delays on both the part of the government and the purchaser, the government was committed to successful completion of the transaction, and saved the transaction at the end of the day. Nevertheless, during that period management felt as if it were in a state of suspended animation.

[8] A major obstacle in Hungary, for instance, is court registration which is needed to transform a company from a socialist format to a modern shareholder company. The backlog is six to eight months, but the SPA cannot sell companies without this transformation.

In September 1992, the Czech Government decided to set up an inter-ministerial privatization commission, known as the Circle of Economic Ministers, as the deciding authority, to replace the cabinet-level Economic Council with respect to privatization through foreign direct investment. This commission has greatly accelerated the process by providing its written comments on these projects within 14 days. Further, every Friday, the Minister of Privatization holds a dispute resolution meeting to resolve any differences. With the Circle of Ministers working in coordination with the MOP, the whole process has become efficient in the Czech Republic.

Lastly, corruption, real or perceived, is felt to be an acute deterrent to the orderly establishment of a free market economy in each of these countries, and that corruption has slowed down the process of privatization, with an adverse impact on enterprise efficiency. Decisions are being made for personal gain rather than economic or business soundness. In an attempt to attract more US investment particularly, the Department of Commerce has investigated the possibility of providing technical assistance to draft white collar crime laws for these countries.

Keeping the Loss-Makers Alive

Loss-makers are kept alive simply for political reasons. In Poland, loss-making SOEs still represent 40 percent of the enterprises, and some 3 million workers. Political risks to the government from forcing many of those 3 million workers into unemployment is leading to slow erosion of the scarce capital and other resources of those SOEs. The rigidity of the labor markets makes it difficult to find alternative employment for workers in other parts of the country where their general skills might also be utilized. Furthermore, the Polish market economy has not been sufficiently established with proper bankruptcy laws, asset sales and social safety nets to allow the market to correct these firms.

In Hungary, a bankruptcy law came into effect in January 1992, which is much stricter than U.S. bankruptcy law in concept; any Hungarian company in arrears for more than 90 days is considered technically bankrupt and is submitted to the courts for liquidation. 1,500 Hungarian companies are technically bankrupt under this law, but the problem resides with an inefficient administration of the law. Courts were not properly equipped to handle the volume of proceedings, so the process is bottlenecked and not really working. In the interim, responsibility of the assets is placed with the SPA, which has the discretion to appoint management to carry out the liquidation of the company. In practice, on a case by case basis, the scope of corporate governance has broadened beyond guiding the enterprise through court ordered liquidations to also investigating the possibilities of trade sales or internal privatizations.

Another important dimension of keeping certain companies in the state sector is the rolc SOEs play in social services, and the present lack of any structure to take on that role should all the large SOEs be privatized. SOEs in Central and Eastern Europe have provided necessary services such as child care, health care, recreation and vacation facilities, and even meals which workers have come to rely upon. Privatized companies will not be able to carry the financial burden of these services in addition to the other needs of the company, so government officials are faced with maintaining some of these SOEs during the time it takes to disentangle these operations from those of the primary purpose of the SOEs. This could be accomplished by privatizing these services as small businesses in their own right. Nevertheless, these services are deemed necessary in order to preserve the social fabric of these countries during otherwise harsh circumstances, which complicates closing the enterprises.

Future Constraints

Adequate training and business education have emerged as critical success factors for these countries. The post-privatization performance of companies in Poland, Hungary, and the Czech and Slovak Republics will be determined not only by the transition to private ownership, but to a large extent by the quality of the managers and directors. Although the managers of the privatized and privately owned companies visited generally appear enterprising and dynamic, there is an evident shortage of trained and experienced managers, particularly in marketing, finance and strategic planning. The shortage will become much more acute as the process of privatization is accelerated, and existing local talent is quickly absorbed.

So far, the governments of these countries have paid little attention to this factor. They have concentrated on design and implementation of their privatization programs. Some facilities for training of managers and directors are beginning to emerge, and there has been an increase in the number of exchange programs between foreign and national universities, as well as business to business exchanges with the West. Western companies operating in these countries are dedicated to training local managers to relieve the financial burden of costly expatriate management; this is not done without risk, however, as western trained local managers are highly susceptible to poaching by other businesses there.

On a broader scale, universities also offer business management courses for students, but most of the teachers have only a superficial understanding of business since they have previously been teaching Marxist economics. On the part of active private business managers there is only a limited demand for intensive training, since they are concentrating all their efforts on establishing and building up their firms and consider training to be a luxury they cannot afford at the present time.

Equally problematic is the acute shortage of persons capable of serving as directors of companies. Outside directors who have been appointed for the several hundred companies commercialized so far in Czechoslovakia and Poland are almost exclusively officials of the branch ministries. They are generally knowledgeable about industry but have no business experience.

The Czech and Slovak Investment Privatization Funds (IPFs), which in the next four years will become the major shareowners of the companies privatized by vouchers, as well as the proposed Polish mass privatization investment funds, will have to appoint hundreds of directors (who in many cases will in turn need to appoint new managing directors of the companies). The IPFs in the Czech Republic have already begun working with management of the companies on these issues. These funds might hire a small number of experienced foreign directors, but most of the directors will have to be local people. In Poland, the Mass Privatization Program (See Chapter V) may facilitate somewhat greater use of foreign overseers or directors through Polands' National Investment Funds. A growing number of companies which will be privatized by direct sales will also need directors.

Similarly, some hundreds of companies, including "strategic" ones such as energy and telecommunications and those which are very large and difficult to privatize, will remain State-owned for a number of years but hopefully will be commercialized. There will be a need for competent directors and managers for these companies as well.

In short, as these countries move forward with their privatization programs, their governments must give a higher priority to expanding facilities available for the training of managers and directors. Furthermore, they must undertake a massive education of the general public and employees, to ensure that growing nostalgia for socialism, such is occurring among the younger generations in Hungary, do not create a tragic backlash against private ownership. The governments should seek technical assistance from multilateral and bilateral sources for such training and education.

CONCLUSION

The underlying assumption to corporatization and privatization, and the creation of a market economy is that this new environment will produce the necessary governance system to lead these new companies to more market-oriented, efficient, and ultimately profitable operations. The experience of these enterprises to the end of 1992 suggests that with the exception of a small number of trade sales involving dominant foreign investors, the sweeping changes in corporate governance necessary for leading these enterprises in a new business environment has not yet occurred in Hungary, Czechoslovakia or Poland.

The structure of country privatization programs has influenced the degree of activism by corporate governance in proceeding with commercialization and then privatization. The interviews of commercialized and privatized companies indicated that many managers have taken major measures to adjust to their changed economic environment, particularly in the Czech Republic, such as laying off workers, cutting product lines, and opening marketing and finance operations. SOE managers waiting for their enterprises to undergo privatization have begun to realize the importance of improving the performance of their firms in order to secure their futures. In this respect, the Czech process of encouraging competing privatization projects on individual enterprises has proven remarkably successful in motivating existing management to demonstrate their ability to improve the performance of their firms.

While the signs are encouraging, constraints continue to exist which prevent a greater change to occur, such as an acute need for training of managers and directors, and the need for government to participate in disposing state assets so that the process is orderly and equitable. In many cases where interim governing bodies have been appointed, such as the SPA, management has expressed concern over the lack of interest taken by these bodies in the welfare of the enterprise. In other cases, such as the Czech Investment Property Funds, where the interim body has a stake in the enterprise, the governing body has worked with management to improve its operations.

For commercialization and privatization to proceed quickly and efficiently, there must be cooperation and active participation of the governing bodies of the enterprises, and that the persons involved be knowledgeable and have an interest in the outcome of the proceedings. There are always a number of objectives that need to be met in these privatization programs in general and for each enterprise individually, such as speedy divestment of state assets, maximizing revenues, safeguarding employment, attracting new investment, and/or gaining efficiencies in the market. Trade-offs naturally have to be made, and the extent that the governing bodies can agree and cooperate with one another on the priorities of these objectives has been a critical success factor.

IV. INTERNAL PRIVATIZATION

THE CONCEPTS

Background

Internal privatization is defined as a privatization process initiated mainly by management and workers as distinct from sales or share-offerings to outside investors. This includes management/employees buyouts, takeovers and liquidations, ESOPs and "spontaneous" privatizations. Importantly, internal privatizations seek to promote domestic ownership of the privatized entities, with the expectation that the individual owners will become involved in managing the newly privatized business. It has been the method by which the majority of large and medium privatizations in Eastern Europe have been completed to date.

This section of the report will review the rationale of internal privatizations and the results of internal privatizations in each country. The programs in each country are examined as well as the reasons for success or failure of each method. Other influences on the process such as political, financial and institutional considerations are discussed. Finally, a number of lessons learned are drawn from the field reports concerning the problems that have been encountered and possible improvements to the process.

In all three countries, privatization has proceeded much more slowly than was originally envisaged. For example, in Hungary, the government had hoped to privatize 80% of the 2,000 medium to large SOEs by the end of 1994; as of -- 1992/93 only 40 medium-to-large-sized SOEs have been privatized. Equally optimistic timetables in Poland and Czechoslovakia were created and abandoned. Early in 1990, each of these countries attempted to priortize one or two large "show case" SOEs as quickly as possible. They were to be used as examples both to their own countries and to the West, that their new governments were serious about economic reform and private ownership. Unfortunately, these early privatizations were problematic and a pattern emerged wherein the bigger the enterprise, the slower its privatization. Methodologies for privatization have changed frequently in attempts to find the "correct" methods, and there has been considerable organizational change within the privatization authorities. All of this has contributed to slowing down the process. Also, concern about excessive foreign ownership (and the suspicion of favoritism in management-led buyouts) has shaped privatization policy in each country.

Many of the earliest privatizations included foreign investors as partners and sometimes majority shareholders. However, beginning in early 1991, there was a marked slowdown in each country in investment inquiries from foreign investors. The reasons for this are seen to be a combination of the following factors:

- the political and economic recession difficulties of the host countries
- major investors have now made their key strategic investments
- recession in Western Europe and the United States
- the foreign investors' perceptions that long, drawn-out negotiations would be needed to complete privatization transactions.

As foreign participation became less realistic, and there were no functioning mass ownership transfer programs (which as of April 1993 continued to be the case in Poland and Hungary) the respective governments turned increasingly to internal privatization as a means of divesting the several thousands of SOEs which remained in each country.

Rationale For Internal Privatization

In essence, there are three underlying policy objectives for the promotion of internal privatization:

- Developing an independent entrepreneurial class;
- Changing the ownership of assets;

- Developing employee ownership.

These rationales are discussed below as a framework for understanding the specific programs.

Developing an Entrepreneurial Class

Although there has been a widespread distrust of the newly emerging entrepreneurial class in each of the three countries, government policy makers have developed an understanding of the need for such a class, and have begun to create programs to facilitate the training and development of entrepreneurs. In the context of internal privatization, the goal is to encourage successful managers of SOEs to become entrepreneurs if they are interested and able to purchase an SOE. Recently developed programs aimed at this group, such as the new Privatization Through Restructuring Program in Poland, shows that policy makers are increasingly aware of the need to support and develop this new class of businessmen.

Liquidation: Changing the Ownership of Assets

An increasingly popular method of changing ownership of state assets to the private sector is through liquidation. Through this process the government sells its assets for the highest price obtainable without regard for what use is made of them subsequently. It may be that the assets continue to be deployed for some economic activity under new ownership, but it is equally possible that the purchaser may buy the assets simply for scrap value. In some forms of liquidation, limited restrictions are placed on future use of assets. This form of privatization allows for the re-allocation of productive assets from less efficient to more productive applications of the assets, but in many cases, the transaction costs of this transfer outweigh the efficiency gains when the new owners are required to invest additional capital to upgrade or modernize the companies.

In many instances, the failure of legal frameworks to address pertinent issues, such as land ownership, delays the process of liquidation where business conditions might otherwise dictate its use. The case of Transbud in Poland[1] demonstrates some of the problems that can be encountered with this method:

a) the difficulty of setting values for the firm's assets, particularly when there is a lack of information to set a market-clearing price, (e.g. only one bidder);

b) potential conflicts on the part of the liquidating agent to handle the liquidation expediently, as their compensation is based primarily on level of effort, not on a percentage of the value of assets sold;

c) the continuing difficulty in verifying true ownership, which causes delays and greatly increases the cost of liquidation.

Further, in Poland, liquidated assets are often purchased not by the management or employees as the government would like, but by competing interests, either state-owned or private, which many feel will create new monopolies and hurt the development of a competitive business environment.

In Hungary and the Slovak Republic, liquidation is seen as a viable method of privatization, although it is not completely straight-forward. The assets of state enterprises are offered for sale by public auction, but are subject to conditionalities regarding their future use. These conditionalities have proven to lower purchasing prices. Thus, the governments have chosen to preserve economic activity and employment generated by the assets, at the sacrafice of financial gains to the government.

Employee Ownership

There are two rationales for using internal privatization as a method of increasing employee ownership. The first is the traditional concept of empowering the workers with a sense of

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[1] Fuller descriptions of these cases are found in Evaluation of Privatization in Central And Eastern Europe: Field Assessments (First Draft Report), January 4, 1993.

ownership and profit incentives similar to policy objectives in western countries. The second, particularly in Hungary and Poland (where there were no mass privatization schemes until late 1993), is to increase the level of share ownership among the general populace. In general, employee ownership tends to be easier to encourage in service businesses than in capital intensive manufacturing businesses because of lower asset values and investment requirements of the service businesses. The most sophisticated of the methods of promoting employee ownership of privatized businesses is the Hungarian MRP (the Hungarian acronym equivalent to ESOP) law of July 1992. This provides a legal basis, including tax incentives, for employees to acquire their company through a trust-like entity. The legislation is based upon ESOP legislation developed in the West. Its centerpiece is financing and tax incentives for the ESOP shares. Its major drawback is the lack of these incentives for contributions to the ESOP after the initial loan is repaid or for companies already privatized. For example, companies that have already been privatized may find it desirable to utilize ESOPs for financing of plant renovation, modernization and re-training. If there were interest rate incentives and tax incentives, companies could be induced to establish ESOPs to provide ongoing benefits for employees while at the same time provide incentives for modernization. The MRP is discussed more fully under the section entitled "Country Specific Techniques - Hungary".

Poland enacted a framework which encourages widespread employee ownership through asset leasing. This method has become the most prevalent method of internal privatization in Poland. A key element of this program is the requirement that at least 51% of the employees participate in the privatization.

The Results

The experiences of Poland, Hungary and Czechoslovakia differ dramatically with respect to the number and types of internal privatizations that have been completed. The following table sets out certain facts and figures concerning each country:

Selected Statistics on Internal Privatization

Poland (2/93)	Number of Transactions	
Capital Privatization	56	
Liquidation by:		
Leasing	575	
Contribution-in-kind	25	
Asset Sales	80	
"Mixed" Sales	66	

Czech Republic (1991)		
Small Privatizations	Number of Transactions	Sale Prices
	14,726	18,122 (Mn CSK)
Slovakia (12/91)		
Small Privatizations	6,723	7,486 (Mn CSK)
Hungary (12/92)		
Self Privatization Projects	257	26.3 (bln HUF)

It is difficult to obtain accurate figures for privatizations completed, particularly in a manner that is comparable between countries. Furthermore, projects in the CSFR mass privatization program often included a mix of techniques whereby a portion of the enterprise was privatized through management buyout and the remaining portion was distributed through vouchers. All of these statistics were obtained from official government agencies.

FINANCIAL FACTORS

The Problems of Cash Flow

Most companies privatized internally are highly leveraged. They must secure sufficient cash flow to service an extremely heavy debt burden. Despite its positive outlook for the future, Czech plastic manufacturer Lisovny Plasteckych Hmot is experiencing immediate cash flow problems just meeting its payments on an interest free loan.[2] Many of the enterprises privatized by asset leasing in Poland are currently running into problems as well despite the fact that the Polish system provides for deferment of two-thirds of the interest in the first year.

Companies which invested in construction of new plants have been able to obtain only relatively short-term bank loans of three to four years to finance a long-term capital investment, imposing a heavy cash flow burden on the borrowing company. Another burden continues to be the inter-enterprise credits, in which SOEs provided involuntary or unwise credits to other enterprises, who would delay payments for goods delivered. While most internal privatization schemes do not involve the assumption of debt, the investors do pay for the inter-enterprise receivables which often turn out to be worth little.

[2] Fuller descriptions of these cases are found in Evaluation of Privatization in Central And Eastern Europe: Field Assessments (First Draft Report), January 4, 1993.

The privatization of GYGV-MONTEX in early 1992 is a case in which innovative financing techniques were applied to allow for employee ownership. In an unusual move, the Hungarian SPA provided cash for the 15% (HUF 120 million) shareholding set aside for employees in addition to the 12% (HUF 100.6 million) provided in cash by the employees, thus making it possible to increase the founding capital and apply for a larger operating capital loan.

In all, these newly privatized companies will encounter major challenges to strengthen their balance sheets in the next few years. The lack of available capital and financing limits the type of enterprises (only those with few fixed assets) for which internal privatization is suitable and the scope for change once they are privatized.

The Relative Strengths and Weaknesses of Internal Privatization

In any privatization, the preference is to find a concentrated group of investors/ entrepreneurs who have the management and technical skills, and the motivation and capital to create and sustain a viable, on-going business. The reality in Hungary, the Czech and Slovak Republics, and Poland is that a limited pool of each of these skill sets exists domestically, and are rarely found together. Internal privatization is the methodology that allows the opportunity for most of this skill set (except capital) to be combined in the new ownership structure while maintaining domestic control.

There are a number of factors which make internal privatization politically acceptable. One factor is that it is a good way of maintaining domestic control of assets. The second factor is that the high level of employee participation, in many instances, helps generate a greater sense of involvement in and acceptance of the privatization process. The Polish law requires at least 51% participation; in the case of Chemira, 98% of the employees bought equity. In the Hungarian case studies, the domestic participation rate was over 75% (e.g., 2700 out of 3558 workers at GYGV-MONTEX).

A third factor is that internal privatization typically follows a "bottom-up" approach. The initiative is taken by the workers and/or management, and they drive the process. In Poland, for example, asset leasing privatizations need only be presented to the central government at the final stages. Because sales to foreign investors are perceived to be decided in Warsaw by the government alone, the infusion of foreign investment causes a much lower rate of both acceptance and favorable outcome in the process.

Clearly, a trade-off must be made between keeping a simple, straight-forward internal privatization program and increasing public comfort through greater transparency and education. One of the major strengths of current internal privatization methods is their relative simplicity. Transparency has been achieved to a degree in the pricing of enterprises. In both the Czech and Slovak Republics and Poland, the initial starting point for pricing and negotiations of a transaction is the book value of the assets; this is similar in Hungary with more emphasis placed on holding to the book value as the selling price, than recognizing it as a convenient point of departure for negotiations. In the Polish and Czech/Slovak methodologies, few adjustments are made to the book value, which allows for speed and transparency in the process. Because most of the enterprises privatized this way have been small to medium in size, this transparency helps reduce the many layers of analysis and review on any given transaction, so that the process costs do not outweigh the benefits of the process itself (which unfortunately happens when these reviews are handled through the central government apparatus).

With respect to creating viable on-going enterprises, internal privatization demonstrates both strengths and weaknesses. The evidence to date is largely anecdotal, but there exists a sense of determination and motivation when visiting the owner/managers of these newly privatized companies. The lack of work ethic which has been used so often to characterize Central Europe seems to be lessening in favor of new management eager to implement new ideas and test new concepts for moving their companies forward. They recognize that bubbling enthusiasm only carries them a short way in the absence of clearly established commercial codes, channels of distribution, functioning banking systems with accessible credit facilities and properly trained workers. They generally recognize that all of this takes time and resources to develop, and they simply hope that these things develop in their lifetime.

While internal privatizations inspire motivation and pride of ownership, they do not transfer management and technical skills. In the example of Alico Record Kolin, the management group appeared to have a good understanding of the product design and technological changes needed to move the company forward, as well as an ability to increase its marketing activity and produce a financial plan.[3] However, it is too soon to tell if they can succeed on their own in areas that have historically been dealt with by others without an infusion of foreign management and technical skills in order to compete in the world markets they have targeted.

Another critical success factor is the creation and maintenance of a sound capital structure. A lack of enterprise liquidity and high debt loads are areas that internal privatizations cannot remedy. Even when the new owners receive concessionary financing, the enterprises still experience cash flow problems (discussed below). In some cases, this problem is rooted in the pricing of the transaction; because of local accounting principles, the book value of the assets often does not bear any relationship to the income producing abilities of those assets. As such, the book values are often far higher than those that would be derived through standard Western techniques, such as discounted cash flow analyses. Therefore, when the new management takes over, they may be servicing much larger loans than the income producing assets can cover, particularly in the short-term.

So, while internal privatization serves the need to build a domestic core of entrepreneurs, it does not supply a solution to the needs of those entrepreneurs.

[3] Fuller descriptions of these cases are found in Evaluation of Privatization in Central and Eastern Eurpe: Field Assessments (First Draft), January 4, 1993.

Changes in Enterprises After Restructuring

There is little empirical evidence that has been collected about the performance of companies after their privatization. Any assessment is complicated by the dramatic changes taking place in the economies of the region, which make it difficult to ascertain the effects of this change. Many of the transactions have only taken place recently, making their operating history too short to draw definitive conclusions. Some preliminary data was captured by the Gdańsk Institute for Market Economics and the Polish Ministry of Privatization showing some initial post-privatization results of several Polish companies that underwent liquidation. This analysis has been focused on broader issues or on the process itself, but a number of interesting points have arisen. Firms that had been privatized by an asset lease under the liquidation method were likely to either make drastic changes in their production, such as introducing new products or businesses, or to make no changes at all. The new management/owners were more willing to take risks and apply their own ideas in an effort to make money quickly. The pressures of needing to generate cash flows for lease payments may also explain their actions. In contrast, all of the 9 firms in the sample who went through capital privatization (a trade sale, typically to the foreign investor) only made modifications to their existing products/businesses. They did not undergo any dramatic changes to their business. A likely reason for the level of changes in "trade sales" is the knowledge of the foreign investor as to the direction they want to proceed and a higher level of capitalization to make the changes slowly.

The Gdańsk survey was not able to come to any conclusions regarding the effect of privatization on the profitability of the enterprise. All firms in their sample (55 firms) recorded sharp drops in profitability during the survey period (January 1990 to March 1992) which ended near the trough of Poland's recession, but it was difficult to isolate any causes other than the general decline of the economy. They did conclude, however, that firms privatized under the capital path were able to maintain their profitability to a greater extent than any other path. Also, commercialization (transformation of the SOE into a joint stock company) had no effect on the profitability of the company. The survey did not provide the information necessary to determine if the companies privatized via the capital method were more profitable due to the dominance of the single shareholder, an infusion of capital, new day-to-day management, or new marketing channels outside the country.

Also, based on the field assessments and case studies collected for the present report, a number of other comments relating to the other countries can also be made. In each of the case studies, the control of the enterprise has gravitated towards a small group of people, typically former management. In the Czech studies, it was former management that bought their companies; however in Chemira, the Polish company, a widespread employee buy-out took place and the shareholders' agreement was still drafted to allow control to rest with the chief executive office which allowed the former managing director to take control of the new company.

The most radical change in any of these newly privatized companies has been an increased emphasis on marketing. Under most of these transactions, the increased debt load meant an immediate need to increase in profitability to ensure the company's continued survival. Most of the management groups understood the role of increased marketing in this equation vis-a-vis other, more difficult or less immediate steps to improve cash flow.

Institutional Structures

There are significant differences between the countries in the institutional structure of their privatization programs. There are also some similarities. In each country the structure used has been changed at least once and, even within a given structure, the role and emphasis of the various institutions has also changed from time to time.

Each country has chosen to appoint a Minister responsible for privatization. In the Czech and Slovak Republics and in Poland there is a Ministry of Privatization. In Hungary, the SPA is not technically a ministerial department but in practice operates very much in the same way as a ministry. It would appear that while the establishment of a ministry of privatization is not essential to the development of a successful privatization program (no such ministry was used in the UK, for example), it is generally held to offer the best prospect of overcoming any reluctance to privatize amongst the "founding" ministries (the ministry with prime responsibility for operating/managing a given state enterprise). It also allows one body to develop the expertise required to generate and/or review and approve privatization plans. In Poland, for instance, during the period just prior to transformation the founding bodies exert very little control over the State Owned Enterprises.

It is in the role of such founding ministries that there exists the most striking differences among the three countries. In Poland, most internal privatizations, (i.e., via liquidations) are generated by the enterprise itself, often in conjunction with its founding body. The central government plays a limited role in internal privatizations. Most small and medium enterprises have local founding bodies. The MOP nevertheless is responsible for the final approval of the privatization of these businesses -- often after the transaction has been negotiated and financing is in place. It is often argued that the decentralization of the process is an important reason why liquidations are so prevalent.

In contrast to the arrangements in Poland, the Czech Republic gives an important role to founding ministries (in Prague) in reviewing privatization plans for their state enterprises. Until a privatization plan has been approved, the founding ministry remains responsible for the enterprise.[4]

In Hungary it has recently been decided that the continued ownership of holdings in certain state enterprises will be the responsibility of a new body, the State Holding Company (AVRT), and the founding ministries participate on an advisory basis in conjunction with the

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[4] After approval of the privatization plan, the MOP takes over responsibility for the privatization. In the Czech and Slovak Republics, an important role is played by the National Property Funds. These bodies, as separate legal entities from the republic Ministries of Privatization, become the legal owners of the shares in those state enterprises which are transformed into joint-stock companies. The Funds then have a continuing role in the privatized enterprises in the majority of cases where the government continues to be a shareholder.

AVRT. The SPA will thus be responsible only for privatization of state enterprises and no longer for the state's continuing interest in them.

Central Government Implementation Capacity

In all three countries there have been numerous complaints about the alleged bureaucracy of the privatization authorities. In the management buyout of the Czech Pistol Hlinsko, it took more than one year for the central authorities to approve a $1.1 million privatization. One very important factor to ensure that the internal privatization program runs smoothly is the extent to which decision-making is decentralized. Currently, in all three countries transactions must be approved centrally -- which slows down the overall pace of privatization. The question arises whether greater decentralization might be possible or desirable in these countries. However, decentralization carries with it certain other disadvantages:

- delay to the privatization program if decisions are delegated to bodies which are out of sympathy with privatization. (There is some evidence of this having occurred in Poland, in the Ministry of Industry)
- lack of transparency
- (probably) less tough price negotiations and an overall drop in efficiency as the officials will not be familiar with privatization, thereby less likely to make decisions.

Astute political judgement must decide how to balance these risks against the potential rewards of decentralized decision-making. There are cases in which explicit decisions were taken not to pursue each price negotiation to the last penny, in the interest of speeding up the privatization program, but these occurred earlier in the development of these programs. The present Polish Minister of Privatization, Janusz Lewandowski, continues to suffer from political attacks as a result of such decisions taken during his first term at the beginning of the program. Accusations of incompetence at best and corruption at worst have dampened the enthusiasm for decentralized decision-making.

Similar issues arise in relation to whether central government decision-making on privatization should be in the hands of a single agency (as, hitherto, in Hungary) or involve several (as in the Czech Republic).

COUNTRY-SPECIFIC TECHNIQUES

CSFR

Internal privatization has not been a major policy aim outside the area of small privatizations, which, as in the other two countries, have proceeded smoothly and rapidly. Although many small scale privatizations have involved internal privatization, the law (Act No. 427 of 1990, "About the Transfer of the State Property and Some Things to Other Legal or Physical Persons") does not provide any special privileges to workers or managers of the enterprise. The initial auctions were only open to CSFR citizens. Nevertheless, due to the slow progress on central government privatization programs for major state enterprises, these smaller privatizations represent the largest number of transactions accomplished. The main focus of establishing domestic ownership of the larger privatized companies has been the voucher scheme of mass privatization, discussed separately in Section V.

The privatization law, while not preventing internal privatization, does not encourage it either, leaving internal privatization very much to the initiative of individuals or groups to propose their own internal privatizations on a case-by-case basis. The result of this legal framework is that all of the companies examined in the CSFR were privatized by management buy-outs; very few employee buy-outs have occurred. In fact during the early stages of the first wave of privatization "projects" the Ministry of Privatization let it be known that it would oppose a stake of more than 10% for employees. There are no incentives to broaden the base of ownership because the National Property Funds have provided interest free financing for the vouchers which cover the majority of price, which is not available to individual investing. The price setting mechanism is based on book value of the enterprises with some relatively minor adjustments which allow for simplicity and transparency.

Therefore, with the exception of some of the spontaneous privatizations which led to trade sales early in the privatization process in Czechoslovakia because those enterprises actively sought external partners, it is unlikely that further innovations in internal privatization will take place, particularly in the Czech Republic where privatization is proceeding rapidly.

All of the Czech internal privatizations examined for this study involved smaller groups of management buying a controlling percentage of the shares of the enterprise with the assistance of interest-free loans, typically over a 3 to 5 year time period. The availability of interest-free loans from the National Property Fund has greatly facilitated the development of entrepreneurs in the Czech Republic. In addition, CSFR banks have also been willing to lend money at reasonable rates (such as the 14% with a 4 year term). Their lending to small scale privatization has increased from 18.2 bn Kcs at December 31, 1991 to 28.8 bn Kcs of September 30, 1992.

Following the separation of the Czech and Slovak Republics the privatization laws remained the same in the two republics (as of April 1993), however, implementation differs. Since the 1992 elections, in Slovakia, political factors and intense nationalism appear to have slowed down privatization, and fundamental rethinking of the process seems to be taking place. The emphasis has shifted from rapid, mass privatization to the much slower case-by-case process.

Hungary

In 1989-90, Hungary was moving very quickly towards developing a private sector, helped both by a cultural tradition of entrepreneurship and the steady development of reform measures that had been building over the preceding decade. Spontaneous privatization was very popular among the management of Hungarian SOEs. The Corporate Act, passed in 1988, allowed for the decentralized privatization which gave the top managers of state enterprises the opportunity to become "privatization agents." There was essentially no control from any state organization, and the managers used their independence to take control of state assets themselves (internal privatization) or to attract foreign investment. Foreign investment reached at least $1.5 billion in 1991, far out pacing other countries in the region.

The spontaneous privatizations typically involved the creation of a new wholly-owned subsidiary from which shares could be sold, or the SOE could contribute some of its assets in kind. According to unpublished data of the Ministry of Trade and Industry, 40% of SOE in the industry, trade and construction sectors had founded several hundred such companies with an average of 10% of their assets being transferred as of mid 1990. The assets of these newly formed subsidiaries were often pooled together with additional capital from either foreign or domestic investors to form entirely new joint ventures.

Unfortunately, the overall privatization process was stymied as allegations of corruption (insiders taking advantage of lack of supervision) and "selling the family silver" to foreigners fired nationalist sentiment. Hungarian public opinion demanded that enterprises were sold at "fair" value. When it was widely reported in the press that business after business was being sold for less than their valued worth, the government was forced to adopt a centralized approach to privatization. In 1990 the State Property Agency was created to administer the "orderly" disposal of state assets.

Due in large part to the national outcry over the relatively high levels of foreign investment in Hungary, a major policy aim of the Hungarian government is now to promote domestic ownership. A variety of methods have been introduced to achieve this, and more methods are under consideration.

The government introduced a new scheme in Fall, 1991 in order to accelerate privatization. The "self-privatization" process targets smaller firms (first below 300 employees and 300 million forints in assets but then broadened to Ft 1 billion in assets; now incorporating potentially 95 billion forints of state assets), the government has declared that these firms must be privatized quickly. This new scheme, although under the control of the SPA, gives these SOEs more responsibility for their own privatization than had been the case earlier.

The state enterprises themselves choose the consultant from the list of about 50 private consultants pre-approved by SPA. Afterwards the consultant acts in the name of the SPA, and the state enterprise has no right to veto its privatization scheme, but is encouraged to work closely with the consultant to ensure a mutually satisfactory outcome. A quick sale of most of these firms was expected but lack of demand as well as uncertainties following the bankruptcy wave of the first half of 1992 caused a much slower than hoped conclusion of deals. By the middle of 1992 only 20 firms were sold and 150 corporatized waiting to be privatized out of the more than 400 enterprises included in the program. Under the self-privatization scheme, employees/managers are given certain preferences: ability to buy "workers shares" at 90% discount (up to 10% of capital) and normal shares at 50% discount (up to 50% of capital).

Although it is too early to evaluate the self-privatization process, its assumed success has encouraged the government to expand the model. After a heavy intra-government struggle, the SPA is expected to announce a "second wave" of self-privatization. Here the upper limit will be 1,000 employees or 1 billion forints asset value but the limits will be treated flexibly.

The Hungarian ESOP

The new MRP (ESOP-like program) enacted by the Hungarian Parliament on June 9, 1992 provides two economic incentives for the establishment of employee stock ownership plans as part of the privatization process: a below market rate loan and a tax deduction to amortize the loan. Under the Hungarian ESOP legislation, an ESOP may be established if 25% of the employees elect to have one, subject to approval by management. While the ESOP structure may be utilized for new companies or companies already privatized, economic incentives are only available for companies undergoing privatization.

The purchase price for the shares of the ESOP will be determined through the privatization process. There is no limit on the number of shares that may be purchased by the ESOP.

The consideration for purchase is provided through financing from the State Bank through a commercial bank intermediary to the ESOP. The State Bank provides financing to the commercial bank at 60% of its base rate, and the commercial bank can add on a small margin for profit. The company must guarantee repayment of the loan by the ESOP. However, if there is a default on the loan, the commercial bank will bear the credit risk.

A small portion of the consideration (generally not more than 2% of the purchase price) is paid by the employees. Employees are entitled to a tax deduction for up to 30% of their income for funds utilized to purchase company stock. The ESOP loan term cannot be more than 10 years, with a 2-year grace period. Participants in the ESOP are not personally liable for the debts of the ESOP. The loan is repaid through contributions by the company to the ESOP which are tax-deductible to the company, up to 20% of the profits of the company.

Any dividend on company securities held by the ESOP can be used to repay the ESOP loan or be paid out to employees under the plan.

Bankruptcy In Hungary

Hungary enacted a new Law on Bankruptcy on January 1, 1992, and has the most advanced bankruptcy regime of the study countries. It has generated a very large number of bankruptcies (financial restructuring in Hungary) and liquidations (a Chapter 7 type procedure), particularly during the period when its provisions first came into effect.

Bankruptcies and liquidations from January 1992 to September 1992

	Bankruptcies		Liquidations	
	Registered	Judicial proceedings started	Registered	Judicial proceedings started
1st quarter 1992	789	285	872	120
April	2259	205	1281	161
May	201	465	837	202
June	145	482	927	166
July	154	300	699	219
August	113	69	701	210
September	151	104	797	472

Source: Heti Vilaggazdasag

The law requires companies to declare bankruptcy if they have liabilities that are more than 90 days overdue. In bankruptcy, the firm has 90 days (the court may extend it by another 30 days) to arrive at a restructuring agreement with its creditors. Unanimous consent is required. In the absence of any agreement within 15 days, the court is empowered to start a liquidation procedure.

The effect of the initial wave of bankruptcies on the Hungarian economy was great. At an international bankruptcy symposium the Hungarian Minister of Finance estimated that one quarter of the Hungary's GDP in 1992 was produced by organizations under the jurisdiction of reorganizations or liquidations. Many economists point to the bankruptcy wave as the single most important factor prolonging the GDP decline in 1992.

The system has not worked very well because of a bottleneck in the judicial system. At the end of 1992, each bankruptcy judge in the Budapest Court was dealing simultaneously with 146 restructuring and 337 liquidation cases. In recent months, creditors have sought to avoid the bottlenecks in the system, and close to 60% of reorganizations have ended with creditor agreement before entering the judicial system.

The creditors can end up holding equity shares in the financial reorganizations. In liquidations the assets are sold outright. Neither instance involves internal privatization *per se*, but they do involve an extensive transfer of state owned enterprises/assets into the private sector and introduce another element of a free market economy to Hungary. Some consulting firms in Budapest have been advocating the use of this process as a method of privatization. Selected assets of the state firms would be acquired by a new enterprise (or old management), dealing directly with commercial banks and the other main creditors/owners rather than SPA bureaucracy.

In the past year, Hungarian privatization officials have developed a number of separate schemes in parallel to address internal privatization, primarily with respect to providing credit. In Hungary, internal privatization offers tax concessions enabling the successful bidder, who must be a Hungarian citizen, to acquire a company (through public tender) by leasing it. The lease payments are expected to be generated out of the company's profits over the period of the lease. The leasing law includes a number of measures designed to tie the lessor into the company and to discourage early sale. In another manner of dealing with lack of access to credit for individual investors, enterprises have sometimes been divided into smaller units, or real estate assets have been stripped out, so as to render them more affordable to individuals.

In an effort to increase the domestic "demand" for state owned assets and develop a class of domestic entrepreneurs, Dr. Tomas Szabothe of the Hungarian Prime Minister's Office, has proposed a number of new techniques. Two of the more important proposals, the credit note and letter of credit, provide a potential investor with the ability to pay for the acquisition.

The credit note, in essence a warrant, has a 15-year term with several years grace. It involves no personal property guarantee and the interest rate is variable, starting at 40% of the national Bank of Hungary's refinancing rate rising to 100% within 6 to 8 years. The credit rate has a maximum value (not yet determined). The letter of credit (for large scale investments) differs from the credit note as it requires a personal and/or bank guarantee and there is no upper limit. Since lack of financing is a major impediment in the initiation and success of internal privatization, these new techniques could be an important factor in alleviating this problem.

Poland

Poland has developed a number of programs which encourage internal privatization. At the beginning of the Polish privatization program, the aim was to navigate a path between the workers' councils and the nomenclatura set (existing management heldover from Communist era). There was a great fear among government leaders that if either party were left to its own devices, there would be no functioning industry left in the country. A clear policy choice to encourage employee/management ownership was made in the summer of 1990 when the Law on Privatization of State Owned Enterprises was enacted. In devising its privatization schemes, the government established guidelines for internal privatization to ensure that a foundation of capital (20% of book value) and management competency (demonstrated through well developed business plans) exist. This was to ensure that whoever took ownership, the enterprise would have at least the basis for an on-going concern.

In the first instance, workers are given the right to purchase up to 20% of the shares of a company at half price in a trade sale (the new state enterprise pact provides for 10% free). Trade sales, the sale of large blocks of shares outside the financial markets, were intended to be the predominant privatization mechanism.

Yet it is in the framework of privatization through liquidation that the government is the main form for internal privatization. Indeed, liquidation has been the predominant form of all enterprise privatization (both in number and volume) in Poland. There are a number of reasons for its dominance:

- it usually involves small and medium sized enterprises which typically are easier to sell
- the process is bottom-up, largely avoiding the paralysis in Warsaw
- it offers potential advantages to insiders and provides them with the ability to control and manipulate the process to their benefit.

Leasing is the most prevalent form of liquidation. Out of 792 privatization transactions completed by February 1993, 73% (575) were liquidated by leasing. There are a number of different types of asset leasing programs (lease and sale, tenancy with and without option to purchase), requiring that a majority of the employees become shareholders and that the new company must be capitalized to a level of at least 20% of the purchase price. Contracts are typically valid for five years, although a ten year term is possible. The lease and sale option is the most popular choice as the lessees are unwilling to take the risk of a rise in the purchase price during the term of the lease.

The price of an enterprise is based on a valuation performed by independent consultants taking into account discounted cash flows and adjusted book values. The assumption of an enterprise's liabilities is a matter of negotiation, although typically the known debts are assumed by the enterprise. Insiders are usually the ones who initiate the procedure and they are the prime bidders for the assets of the liquidated enterprise. They have the most access to information and actual control over the enterprise's operations and are clearly interested in coming up with a low valuation prior to the leasing contract. The bargaining over the value of the assets takes place with the enterprise's founding body.

There have been certain instances where, under the lease and sale option, management will enter into a lease with the founding body and <u>then</u> proceed to enter into an arrangement with a foreign party. The management/workers are typically able to get a much lower price for the enterprise (more attention is given to purchases by foreigners) and they can then profit by selling a part of their interest (but not ownership as title does not pass until the end of the lease).

The purchaser of the enterprise receives interest rate relief during the first 2 years, with only 1/3 of the interest due in Year One, and 1/2 in Year Two. The interest rate is three-quarters of the National Bank of Poland's refinancing rate -- well below the prevailing rate of price inflation. The law provides for the deferred interest to be paid in Year Three along with the normal interest. As many of the liquidated enterprises approached Year Three it was anticipated that the law might have to be changed to forestall a wave of bankruptcies. The typically high initial price, combined with the economy's poor performance in 1991-92 made it difficult to generate sufficient cash flow, although the upturn in Poland's economy in 1993 may have altered that situation.

Another form of liquidation is the sale of assets. These liquidations are done by public offer but typically the process is controlled by insiders. The government provides assistance to domestic buyers, including the ability to pay in installments over 4 years (1 year grace period) with an initial payment of 40% of the total and a reduced interest rate similar to the leasing program.

In the summer of 1992, a new privatization scheme was enacted by the Polish government, Privatization Through Restructuring. The scheme allows private entrepreneurs to gain control of an enterprise with very little upfront capital required. Although, in theory, the scheme is open to any investor, this form of privatization is most conducive for existing management to bid for the management contracts. It involves the submission of business plans for an enterprise by competing management groups. The Ministry of Privatization will select the plan which is most feasible and offers the highest initial value for the company. This management group then enters into a management contract with the Ministry. They have to deposit 5% of the initial value of the company. The restructuring and actual sale of the company is expected to last 2 - 4 years. After the sale (at least 51% in private investors hands) the management group will receive a commission amounting to 70% of the increase in the value of the company. There are 15 companies in the initial pilot project. Although substantial effort and donor funds have been spent on this program no enterprises have passed through the process yet. It is anticipated that certain contracts may be awarded by mid-1993.

Financing New Ventures in Central Europe

The privatization of the state enterprises in central Europe will require the financing of thousands of transactions. This is crucial to changing the ownership of a high proportion of the economy in each of the countries regardless of the privatization methodologies employed. There is very limited domestic capital available, and it is not clear that there exists sufficient interested among foreign investors to finance what cannot be covered domestically. Even if there were, such widespread foreign ownership would be likely to raise difficult political questions, as discussed above.

One method which has succeeded in tapping the limited domestic markets is the flotation of shares in particular enterprises (Initial Public Offerings or IPOs). Poland, in particular, has had great success financing privatization transactions in this manner. Often the strong demand from individual investors has caused IPOs that were initially considered difficult to be oversubscribed. In the critical stages, the IPOs were time consuming and expensive, but recently local advisors have increasingly been managing the process which has lowered transaction costs. The sale of a significant block, often to a strategic investor, can be combined with this method to provide for more effective corporate governance.

In the socialist system, enterprises had little, if any, concerns over financing. Investments by enterprises were financed mostly out of budgetary grants and the enterprises' own funds. When these were insufficient, enterprises could easily obtain bank credits that were centrally allocated at low interest rates, regardless of the creditworthiness of the borrowing enterprise or the economic and financial viability of the project to be financed. Credit for working capital was also provided by the banks with no set maturity dates and at low fixed interest rates ("perpetual accounts").

In the last two years financing has become a central problem facing enterprises in general, and private companies in particular. First, in order to make the cash down payment required for acquisition of a SOE or to establish a new company, the proposed owners must raise some minimum amount of capital, most of which they must borrow. To obtain a bank loan they need to provide collateral required by banks.[5] The existing financial systems in these countries do not yet put domestic investors on equal terms with foreign investors, and there is a strong political case for equalizing the position. For instance, under the current laws in Poland, only foreign joint ventures are eligible for tax holidays, and the Ministry of Finance has decided to no longer grant the holiday for domestic companies except for financially distressed enterprises.

In the large SOEs, one of their impediments to privatization continues to be their huge debt burdens. Most of the privatization candidates can produce plans for enhanced performance in the long-term, but find it very difficult to address their short-term working capital needs in light of their debt levels. Banks in the West play an important role in deciding the appropriate structure of a loan with respect to the enterprise's circumstances and their ability to service that loan; when companies cannot meet their debt obligations, bank work-outs commence to determine what actions (if any) can be taken to help the company meet at least a part of its obligation.

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[5] Due to a very low equity base privatized and new private companies must obtain bank credits for working capital, as well as for financing necessary capital investments. The major problem is the collateral required by the banks. The banks consider private companies to be risky borrowers since they lack a satisfactory credit record; therefore, the banks require collateral in the form of property, and preferably real estate, for 100 to 200 percent of the loan. Czech banks do not generally accept receivables as collateral for working capital credits. In the case of Stival, a Czech enterprise, the domestic owners/managers had to mortgage their homes as collateral for working capital credits, and even some of the workers agreed to mortgage their homes. The same company also received a guarantee of its Italian major shareholder for a loan, to finance investments, provided by Czech banks, without which it would not have been able to get the loan.

Banks in this region, however, find this a difficult role to play because they lack sophisticated skills in credit analysis and risk assessment; rather than structure loans so that they are appropriate to the borrower, the banks give "vanilla" loans. In fairness, the banks not only lack proper training to undertake the necessary work-outs to reduce these debt burdens, but they lack the basic financial tools, such as sufficient accounting standards which present the true financial position of the enterprise. Without mechanisms such as proper assessments on the front-end and work-outs in the event of loan defaults, the domestic capital markets will never become a viable mechanism for financing privatization and wider private sector development.

There are, therefore, strong links between privatization, and in particular internal privatization, and the modernization and development of better credit markets in the banking sector in these countries. Pending that reform, privatization and financing techniques must be developed to assist domestic investors who lack liquid funds to acquire privatized businesses. The case studies demonstrate certain techniques that have allowed management/employees to buy the enterprises. Yet these techniques either lead to highly leveraged, fragile balance sheets or must involve businesses, particularly in service industries, where the principal assets are people (rather than plant and equipment) which require relatively low initial levels of capital investment. The creation of new financial tools to further the process of internal privatizations must be tempered by the desire to have insiders incur substantial financial risks and not simply shift them to financial institutions and the government.

CONCLUSION

Internal privatization is the most prevalent method among completed privatizations in the three countries for medium and large enterprises. The reasons for this include: the relative ease of the process, the bottom-up participation of management/workers, and the absence of foreign participation. The absence of foreign participation in these internal privatizations greatly speeds the process (lower level of political review) although this trade-off may be more costly in later stages of restructuring when technical and managerial skills, and capital are in short supply.

One could argue that internal privatizations have been successfully completed because in many respects they represented the "easier" aspects of privatization, namely the sale of the more attractive state enterprises and privatizations led by reform-minded management/employees. The importance of having successful first privatizations cannot be understated, but what about the others? Internal privatization is difficult to accomplish in larger enterprises or those which utilize a great number of assets. The amount of capital that can be generated by the workers/management is typically too low. As discussed above, both the Hungarian and Polish governments have policy initiatives which may solve this problem. Internal privatization can be effective in a number of areas but it cannot be the only method.

The following section examines the mass privatization program as a technique to quickly privatize hundreds of enterprises while seeking to distribute ownership equitably among the population.

V. MASS PRIVATIZATION

Mass privatization schemes promise rapid privatization with widespread involvement of the populace. Not surprisingly, however, these schemes are exceedingly complex, hold many pitfalls, and, if not developed carefully, can both delay privatization overall and undermine public support for this reform. It is important that countries beginning their privatization programs examine the options in designing them.

Countries engaged in designing mass privatization programs can benefit from the experiences of the Czech and Slovak Republics and Poland[1] to date. The innovative method known as "large scale privatization" in the Czech and Slovak Republics (called here the CMPP) and "mass privatization" in Poland (PMPP) has in fact been adopted by other Eastern European and the countries of the Former Soviet Union (FSU), countries as diverse as Lithuania, Romania, and Kazakhstan. Mongolia has largely implemented such a program; Russia is currently carrying out its own Mass Privatization Program (MPP), modeled in large part on the Czech and Slovak one.

This section examines the CSFR and Polish mass privatization programs in some detail. It looks at the lessons learned and how they apply to subsequent stages of implementation in those countries as well as in countries currently embarking on the process.

A word of caution is in order about the significant problems involved in comparing the privatization programs of the Czech and Slovak Republics and Poland. What is being compared is one program that has become a reality and one that is still a theoretical construct. After some delay, Czechoslovakia launched the CMPP and is implementing it dynamically. As of January 1993, it had moved 1,968 firms through the first and second wave of the process, had issued over 8.5 million vouchers to Czech and Slovak citizens to allow them to acquire shares in firms being privatized or in newly established investment

[1] For convenience, in this paper both processes are called mass privatization.

funds, and 435 Investment Privatization Funds (IPFs) have formed to accumulate vouchers and bid for shares. Now underway, the Czech and Slovak mass privatization program is having to overcome all the dilemmas that complex, dynamic processes and systems produce. The Polish mass privatization program has not yet been initiated.

Whereas other forms of privatization have moved ahead, the PMPP has become extremely politicized and was long stalled in a fragmented Parliament. In April 1993, parliament finally approved the PMPP.

Despite the different stages of the two programs, both have been clearly articulated. The comparison is therefore both feasible and useful.

Mass Privatization Defined

Mass privatization involves the bundling or grouping of firms to be privatized, as opposed to the "classical" case-by-case approach taken in the United Kingdom that is being emulated in many developing countries in Latin America and Asia and by Hungary in Eastern Europe. In the Czech and Slovak Republics and Poland, in contrast, the primary objective of the privatization program is to create a base for a market economy by privatizing SOEs as quickly as possible. For example, in the Czech Republic, the objective is to privatize 85 to 90 percent of the medium- and large-size SOEs by 1994. Clearly, this number of privatizations could not be achieved case-by-case using classical methods, although selected firms and sectors will need to be and have been privatized in this way. For such large-scale activity, a mass privatization approach is needed.

Mass privatization may include the distribution of shares in SOEs to the public, either free or for a minimal charge, usually through a voucher allocation scheme. Other approaches to Mass Privatization include: (a) deep discounts, including low floor prices at auctions; (b) transfers to entrepreneurs at book value; and (c) leases.

Of these options, vouchers have proven particularly popular. Mass privatization in Eastern Europe has been associated with voucher distribution systems. The vouchers, which are certificates or scrip, are distributed to the population. They entitle the owner to convert the paper either into shares in SOEs at an auction or into investment funds that have been formed to intermediate the vouchers. In both the Polish and the Czech and Slovak mass privatization programs, vouchers have an integral role. In Poland the holders of vouchers (called share certificates) will only be able to convert their shares into financial holding in investment funds, which in turn will own an interest in and manage a portfolio of SOEs. Several other countries are using voucher schemes in their programs--for example, Lithuania, Russia, Mongolia, and Romania--and their use is planned in still others, such as Kazakhstan. Because of their popularity, voucher schemes are discussed extensively in this paper.

Objectives of Mass Privatization

When policy-makers in Poland and Czechoslovakia began to consider how to reform the SOEs, they recognized there was relatively little private capital formation in their countries, limited interest or perhaps confidence on the part of foreign investors, and a political limit on the sale of SOEs to foreigners in any event. They also wanted to involve their citizens in the economic transformation through wide distribution of ownership. Given these factors, they decided to initiate their mass privatization programs. The overall objectives of the programs are:

- political -- to involve and gain the commitment of the population at large in the economic transformation

- social -- to achieve some form of distributive equity through the distribution of shares to the general public

- economic -- to privatize a large number of firms on an accelerated basis to deepen the market forces and develop competition within the economy.

Other objectives, such as restructuring the privatized firms to generate more productive and operational efficiency, reducing fiscal deficits, strengthening vorporate governance and deepening capital markets, are common to most privatization programs. However, the two alternative methods of mass privatization discussed in this paper are very dependent on the creation of active capital markets. Thus the formation of investment funds (similar in many respects to mutual funds) and the trading of shares in these funds and in their underlying holdings forms are important objectives of mass privatization.

Two Models of Mass Privatization

The Czech and Slovak and Polish programs offer two alternative models for mass privatization. The CMPP employs a bottom-up approach. With some strategic exceptions, SOEs or bidders for them are supposed to prepare their own privatization plan, guided by the founding (line) ministry and reviewed by the Ministries of Privatization in each republic. Many enterprises presented privatization plans which did not involve vouchers; however, at a minimum, the plans required that at least 3 percent of the shares in joint stock companies be reserved for the restitution funds. Other enterprises participated, to varying degrees, in the voucher distribution, some up to 100% (inclusive of the share allocated for restitution). In the case of medium- and large-size SOEs, privatization through the voucher system is emphasized. Each citizen can purchase a book of vouchers and can bid at an auction for shares in an SOE of their choosing. Alternatively, financial intermediaries--IPFs--can compete to attract voucher holders. These intermediaries in turn will bid for blocks of shares in the SOEs at auction.

The features of the Czech model are:

- bottom-up or company-directed privatization;
- maximum emphasis on free market bidding for firms to be privatized through the voucher process;

- emphasis on the rapidity of the process and involvement of the public as investors at the earliest possible moment;

- early emphasis on privatization through vouchers, although other privatization methods were available for the enterprises, and were detailed in the documentation provided to them by the Ministry of Privatization;

- promotion of foreign investment in the mass privatization program;

- promotion of competition in the privatization by allowing other groups or individuals to submit competing privatization projects;

- little initial concern with prudential regulation, particularly of financial intermediaries, which ammend large blocks of vouchers and which could conceivably concentrate large holdings of SOEs in their hands; the Czech Republic officials, however, quickly realized the need for such regulation and has put limits on Fund ownership as well as more carefully defining the roles of these intermediaries;

- no attention to the possibility that vouchers could lead to highly dispersed ownership of enterprises ("orphan enterprises") and the absence of a major shareholder to oversee management and the necessary restructuring of these enterprises. (However, this concern may prove to be largely unwarranted as the Investment Funds seem to be taking or planning a major role in managing the on-going business of the companies in their portfolios);

- little emphasis on social and economic equity when bidding for SOEs, other than the initial distribution of vouchers to the public--in other words, "let the buyer beware" when converting vouchers to shares in individual companies or investment companies.

The Polish model, the PMPP, is more top-down and cautious about the risks of market-driven privatization. Initially, the Ministry of Privatization (MOP) chose an initial group of 200 medium- to large-size SOEs for the first phase of its mass privatization program (now expanded to 600 firms). The MOP has always emphasized voluntary commitment by the SOEs to the process, but in reality it has made the initial selection.

The Polish model calls for the formation of an initial group of 20 financial intermediaries--National Investment Funds (NIFs)--that would be allocated approximately 30 SOEs each through bidding. The Funds would manage their portfolio of firms as a form of closed-end mutual fund for an initial period and then would convert to open-end Funds. The Polish model seeks to attract high quality or "brand name" investment managers from the advanced industrial countries to manage the Funds. These managers would operate on the basis of a management contract that offers substantial upside rewards for increasing the long term value of the Funds by restructuring the underlying assets in them, i.e., the former SOEs.

The Funds would initially own 33 percent of some SOEs in which they became lead managers, plus some percentage of all SOEs privatized under the process; Polish workers would own 10 percent. The government would hold 30 percent for later divestiture, with its ownership interest represented by a lead Fund. The Fund manager would have absolute management discretion over the primary assets managed by the Fund. The boards of directors of the Funds would follow the German model of dual supervisory and management boards. The supervisory board would be composed of Polish citizens appointed by the government, to include members appointed by labor -- helping to allay public concerns and perceptions that foreigners are taking over Polish firms. The Fund manager would appoint the majority of the management board. Polish citizens would then acquire shares in these Funds through the conversion of vouchers, after an initial year of operation and after completion of the first year's audit of the Fund. Once the vouchers are converted into shares, the Funds will then trade on the Polish stock exchange.

The difference between the Polish and Czech and Slovak models is that the former emphasizes the financial intermediaries created by the government and the diversification of risk for citizens by initially holding their shares in the Funds rather than in the SOEs directly. The Polish concern is with the equity of the system and avoiding initial losses by citizens. A further emphasis is to deepen the capital market as an inherently important part of privatization and to establish the preconditions for the restructuring and modernization of privatized firms.

At the same time, the Polish model lacks the market qualities or dynamics of the Czech and Slovak approach. In the Czech Republic, market forces have resulted in voucher holders having the choice between investing in directly in the enterprises or investing through the Funds, in the same way that American investors can either buy stock in a company or through a mutual fund. In Poland where the government has not involved the population in the process, it has achieved less popular political support. The government will try to overcome this problem by distributing share certificates to the population as soon as possible following parliamentary approval of the program.

The PMPP can be characterized as follows:

- top-down selection of firms for mass privatization, and a significant emphasis on preparing them for privatization through the use of external consultants and accountants. As such, the process is inherently slower than the Czech and Slovak approach.

- use of financial intermediaries, which will be led by well-known investment firms in the West, to manage the SOEs initially and prepare them for eventual market flotation, subsequent divestiture, foreign investment, etc.

- use of the financial intermediaries to diversify the risk to Polish citizens and thereby hopefully to reduce the initial potential for inequity in the system.

- establishment of prudential limits to avoid excessive concentration of ownership by the Funds or in the Funds.

- a less market-driven process than that of the Czech and Slovak model, with no early involvement either by the firms being privatized or the public at large. These features and the involvement of foreign Fund managers may have made the PMPP an easier target for political attack, particularly in the splintered Polish Parliament and within dissenting areas of government such as the Ministry of Industry.

Components Common to the Two Mass Privatization Systems

While the two models appear to embody distinctly different approaches to privatization, in fact their common elements outweigh their differences. Of particular importance are the investment funds, which are intended to provide interim governance of newly privatized firms and to deepen capital market activity. For mass privatization to occur, a scheme needs to contain the following features, which are found in both the Czeck and Slovak and the Polish systems:

- selection of the firms to be privatized.

- corporatization of the firms.

- a way to govern the firms and prepare them for privatization.

- clearly established property rights.

- a method for valuing the firms, their assets and liabilities, and their shares at the time of corporatization (commercialization).

- pro-competition or anti-trust review prior to privatization to address multi-plant monopolies or highly concentrated market structures.

- clearly established rules of the game for foreign investors.

- prudential guidelines and supervision for the financial intermediaries to avert fraud and mismanagement.

- a method whereby the public can be allocated and/or can bid on ownership in firms or intermediaries, such as with cash vouchers, or alternative methods.

- a state property agency or treasury to retain the residual shares being held for later privatization or for other revenue-generating purposes such as increasing the liquidity of national pension funds.

- a clearly defined approach for making citizens eligible for vouchers and a system for printing, distributing, trading, and converting vouchers into shares in intermediaries or enterprises undergoing privatization.

- institutional, advisory, and financial support for the implementing agencies, generally a ministry of privatization, and other related agencies, that allows them to proceed in a timely and professional manner.

- a public information campaign that educates the public, enterprise managers and workers, and involved public officials about the process.

2. MASS PRIVATIZATION IN THE CZECH AND SLOVAK REPUBLICS[2]

Various means of privatization were considered in Czechoslovakia. The desire for a rapid transformation meant that the use of standard methods alone (i.e. public sales, auctions) was not possible in Czechoslovakia, given that the level of public savings was not enough to buy all of the state property. This problem was especially acute because most citizens with a significant amount of savings were either ex-party members or ex-black-marketeers, neither of them very popular. Alternatively, efforts to sell off to the first coming foreign company were seen as a politically unacceptable form of "spontaneous" privatization, that could provide existing managers, often communist party functionaries (nomenclatura) "golden parachutes" after selling out to foreigners at low prices.

The final resulting plan in Czechoslovakia allowed those proposing to privatize an enterprise to choose from a variety of means of privatization, with government organs responsible for deciding which proposed method is the most applicable. The Federal Ministry of Finance's original blueprint, described below, envisioned a structure of the privatization process which has more or less held to date, although the role of certain actors in the process, and the timing of the process overall, have changed to some degree.

The Large Privatization

Restitution

One part of the large privatization was played by restitution, the return of property to original owners or their heirs. The large restitution law passed in February 1990 covers assets expropriated through the nationalization effort which started February 28, 1948 and also covers forced gifts and out-of-law restitutions and rehabilitations. This law gives the

[2] This section of the paper is based largely on Michal Mejstrik and James Burger, "The Czechoslovak Large Privatization," Working Paper No. 10, CERGE, Charles University, Prague, July 1992. The status of the program and data have been updated through October 1992.

Fig. 2 **TIME TABLE FOR ONE WAVE OF PRIVATIZATION**
(including actual dates of CSFR first wave)

<u>SUPPLY</u>	<u>DEMAND</u>
Privatization Projects Prepared (first wave: basic projects prepared first [by Oct.31, 1991], then competing projects [by Jan. 20, 1992]) (second wave: all projects prepared at the same time [from April-June 16, 1992])	**Vouchers Sold and Registered** **Standard methods used to express demand for enterprises and constantly updated (bidding, proposals of direct sale)**
Review of Projects by Branch Ministries (first wave: undefined, sometimes coinciding with review by the Privatization Ministries) (second wave: branch ministries will have two months after projects are submitted)	**IPFs founded (Oct. 1991-Feb.28, 1992), list of IPFs publicized, IPF advertising campaigns begin**
Review of Projects by Privatization Ministries, primarily review of projects involving vouchers (Jan-Apr 1992 -- in the second wave, the Privatization Ministries will review projects only after branch ministries have completed their reviewing process)	**"Zero Round" -- citizens allocate investment points to IPFs (Mar 1-Apr 26, 1992)**
Registration of Firms by Commercial Courts (Apr-May 11, 1992)	

PUBLICATION OF LIST OF ENTERPRISES IN VOUCHER PRIVATIZATION
(May 18, 1992)
VOUCHER PRIVATIZATION
(First wave: Round 1:May 18-July 7, 1992, Round 2:July 8-Aug. 25, Round 3:Aug.26-Oct.6, Round 4:Oct.7-Nov. 17)
FURTHER PROJECT EVALUATION BY PRIVATIZATION MINISTRIES, PRIVATIZATION THROUGH STANDARD METHODS

<u>Note</u>: remaining projects that involve vouchers will be included in the following voucher wave.

Table 2	Privatization Projects Proposed by the Final Deadline, Czech Republic	
Proposed Method of Privatization (note that many projects proposed more than one method)	**Number of Projects**	**Share of Total Projects**
A: Public Auction	1,150	10.5
B: Public Tender	872	8.0
C: Direct Sale to Predetermined Buyer	4,905	44.8
D: Commercialization of SOE to Joint-Stock Company: also a precondition for voucher privatization	2,452	22.4
E: Privatization of an already existing state owned joint-stock company	432	4.0
F: Unpaid Transfer to municipalities, pension funds, banks, or savings banks	887	8.1
Voucher Privatization (Out of D and E)	2,523	23.0
TOTAL NUMBER OF PROJECTS	10,949	100.0
Basic Projects	2,884	26.3
Competing Projects	8,065	73.7

Source: Karel Cermak, Czech Republic Ministry for the Administration of State Property and its Privatization

full rights to return the property or to provide other forms of reimbursement to original owners whose property was expropriated or who were forced by tax and rental policy to provide their property to the state as a gift in 1950's and 1960's. Under this law, more than 20,000 demands for restitution have been met. Many involve financial reimbursement or ownership of shares rather than actual return of property.

All privatization projects which are submitted for approval must provide confirmation that restitution claims have been met, or must provide a means of meeting restitution claims. In order to compensate for restitution demands, 3% of the value of shares in share purchases of firms are set aside in a National Restitution Fund. In the case of asset purchases, there are no shares distributed, so cash payments are made for actual specific claims. The original property owners (physical persons only, not former shareholders) are also given priority in buying back the parts of companies which are not subjected to restitution (i.e. parts which were newly erected after the firm was expropriated).

The Waves

Two waves of privatization were scheduled. Both waves were under way by September 1993 and all privatization projects had been submitted for the first wave, and the Ministries of Privatization have completed the approval process for all projects which are included in the first wave of voucher privatization. For the second wave, all projects were submitted by July 16, 1992, except for in selected branches of the economy (e.g.health care). The first wave of voucher privatization is by now nearing completion.

Although the process has basically been enacted according to plan, the originally envisioned time-table of the large privatization changed somewhat (see figure 2), and will be slightly different in the second wave from the time-table in the first wave. The original goal was for all projects to be submitted by October 31, 1991, with the first round of voucher privatization getting under way soon after the New Year. The Ministries of Privatization decided, however, to extend the deadline for submission of competitive projects for over two months. The start of the voucher process was further delayed because a larger number of competing proposals were submitted than had been expected, and thus the Founder Ministries and the Ministries of Privatization required more time to evaluate and approve projects. Thus, instead of the originally planned January 1991 start, the first round of voucher privatization actually began on May 18, 1991.

Even such a slight delay was avoided in the second wave. A list of all enterprises involved in the second wave was published on April 16th, 1992, and all proposals -- both basic and competing -- had to be submitted within two months of this date (i.e., by June 16th). This alleviated the perceived problem that writers of competitive proposals had somewhat of an advantage in the first round, since their projects were written later, and thus they were able to respond to rules shifts and use more complete information (a complete description of the privatization process to date is provided below).

When looking at the overall process of privatization, it is important to remember that voucher privatization is only one of several possible means of privatization which are being used. Although we will describe the voucher privatization in greater detail than other methods, this is because of its novelty, <u>not</u> because it is the exclusive or even the primary means of privatization.

<u>Submission of Privatization Projects</u>

In the Czech Republic, by the final deadline for submission of first wave privatization projects (January 20th), the number of submitted projects reached 10,949 (see table 2 for a breakdown of submitted projects by proposed privatization method, see table 3 for statistics on the authors of privatization projects). These projects were for the privatization of 2,776 firms scheduled for the first wave. The number of projects submitted (which actually increased to 11,291 including projects which were accepted after the deadline) was much larger than had been expected. Part of the cause of this development was that the original deadline for submission of projects -- Oct. 31, 1991 -- was moved back by more than two months in order to allow more submission of competitive projects.

The original Law on Large Privatization anticipated that privatization projects would <u>usually</u> be suggested by the enterprise that is the subject of privatization. Nevertheless, of the submitted projects, only about one quarter were proposed by firms as basic projects, while nearly three-fourths of proposals came as competitive projects. In fact, competitive projects were strongly supported by the liberal approach of the Privatization Minister Tomas Jezek, who was the motivating force behind the decision to extend the deadline for submission of competing proposals. For some companies, in fact, there were as many as 20 or 30 different projects from various bidders; on average, there were four bidders.

TABLE 3 ELABORATORS OF PRIVATIZATION PROJECTS		
Author	**Number of Projects**	**Percent of Projects**
Enterprise Management	2804	25.1 %
Management of Individual Plants (Subordinate Management)	416	3.7
Interested Buyer	4379	39.2
Original Owner	397	3.6
Ministry	22	0.2
Consulting Firm	334	3.0
Local Privatization Council	760	6.8
Other	1451	13.0
Local Founding Institution	431	3.9
Trade Union	19	0.2
Not Listed	153	1.4

Source: Karel Cermak, Czech Republic Ministry for the Administration of State Property and its Privatization

As can be seen from table 2, most of these projects did not intend to utilize the voucher system, and in fact most competing projects suggested direct sale or other classical methods. From table 3 it can be inferred that most basic proposals were written by management, while most competing proposals were written by parties interested in direct sale. The large influx of competing proposals actually changed the originally planned structure of privatization activity and made it more difficult to prepare the supply side sufficiently for voucher privatization. As mentioned above, the Federal Ministry of Finance originally preferred voucher privatization over other privatization methods, and saw the role of the Ministries of Privatization as one of ensuring that projects were properly processed, to ensure that restitution claims were addressed, and to decide on the role of foreign investors. As a result of the unexpected storm of competing proposals the Ministries of Privatization gained a great degree of decision making power in an extremely short period.

At the beginning of the project evaluation period, emphasis was on projects involving voucher privatization, so that the republics could direct the required amount of property to the voucher process in time for it to start in May. The original agreed upon amount of property to go to the voucher privatization was 260 billion Kcs worth of assets ($9 billion). Originally, this amount was supposed to include 140 billion Kcs from the Czech Republic, 70 billion Kcs from the Slovak Republic, and 50 million Kcs of Federal property. The federal contribution amounted to only 12 billion Kcs (most former federal property has been transferred to the republics by now), so a new level of contribution of each republic had to be defined. The final calculated amount was 173 billion Kcs ($6 billion) of book value of assets from the Czech Republic and 75 billion Kcs ($2.8 billion) from Slovakia. This ratio between the two (2.29:1) corresponds to the ratio of voucher holders in the Czech Republic to those in the Slovak Republic.

The Ministries of Privatization reviewed projects involving voucher privatization first, in order to approve enough property for the voucher method to start by the target date of May 18. By the deadline for approving projects for the voucher privatization, each republic had actually exceeded its required contribution (with a reserve in case some firms would not be registered in the commercial courts in time for privatization -- firms that were approved for vouchers but not prepared in time for the first wave will be privatized in the second voucher wave later in 1993). The Czech Republic designated 201 bil. Kcs ($7 bil.) worth of property for the first wave of voucher privatization, encompassing 943 joint stock companies (actually, 216.7 bil. Kcs worth was approved for vouchers, but some will have to await the second wave) and the Slovak side provided 85 bil. Kcs ($3 bil.), including 487 joint stock companies (see Table 4). The total net value of property designated to the voucher privatization was thus about 300 bil. Kcs ($11 bil.), well above the originally planned 260 billion. In Slovakia, it was common for firms to allocate all of their property (except 3% of each enterprise, which is put aside for remuneration of restitution claims) to the voucher privatization, while in the Czech Republic this practice was less common. In fact, Slovak enterprises undergoing voucher privatization allotted on average 74% of their equity to vouchers, while Czech enterprises allotted only 62%.

TABLE 4	Voucher Privatization in the CSFR			
	Czech Rep.	Slovak Rep.	Federal	Total CSFR
Total Number of Enterprises in Voucher Privatization	943	487	62	1492
Total Book Value of Property of these enterprises (bil. Kcs)	362.2	133.6	72.8	568.6
Total Equity of these Enterprises	323.1	114.4	25.4	463.0
Total Value of Property to be redistributed through Vouchers	200.8	85.1	13.5	299.4
Thousands of Workers employed by these firms	864.4	344.2	49.8	1258.4
Combined Output of these firms	592.9	196.3	112.9	902.1
Combined Profit of these firms	67.8	15.5	22.6	105.9

Source: Karel Cermak, Czech Republic Ministry for the Administration of State Property and its Privatization

To date, the lion's share of property which has been approved for privatization is directed toward the voucher method. The reason for this state of affairs is simply that the Ministry of Privatization decided to review projects involving vouchers before concentrating on other privatization projects, in order to allow the voucher system to get under way by the agreed upon date of May 18th. Since this milestone was reached, the shares of other forms of privatization have been increasing. It should be noted, however, that not all were pure "voucher" projects; many of these also distributed a portion of the enterprise's ownership through other means such as management buy-out, direct purchase by Czech entrepreneurs, or purchase by foreign investors.

For the first wave, nearly 3,000 basic projects were submitted in the Czech Republic (about 11,000 projects overall -- see table 2), which means that by the end of the wave, it is likely that between 3,000 and 4,000 projects will have to be approved (since some enterprises will be broken up). For the second wave, almost 4,500 projects have been submitted on over 900 enterprises (see table 6, below). According to the latest figures (late October), over 8,000 projects have been assessed, out of which over 1,700 were approved. In sum, these statistics mean that the Ministries of Privatization still have quite a lot of work -- about 3,000 first wave projects and almost all of the projects from the second wave -- facing them, and that the structure of methods used to privatize will change more by the end of the wave. In Slovakia, 1,500 projects were submitted on 736 enterprises, of which 430 were approved for the voucher privatization (487 units after some enterprises were broken up).

The Demand Side of Voucher Privatization: Public Voucher Registration and Investment Funds in the First Wave

The demand side of the first wave encountered some unexpected twists. Originally, people had put off buying booklets until the last months, perhaps because they were not attracted by the official campaign. By January 10th, only 2 million voucher booklets had been purchased in both republics, and it appeared that the expected number of participants, 4-5 million, would not be attained. But then privately established Investment Privatization Funds (IPFs) opened their advertising campaigns unexpectedly early, promising options to buy back their shares if the voucher holders would invest into their funds. This option was interconnected with a promise to pay back not the actual market value of portfolio, but at least ten times the registration fee of the coupon book. Expected book value per voucher holder at that time was close to 70,000 Kcs with 3-4 million expected participants.

These aggressive advertising campaigns and the impending end of the registration period attracted large crowds to the registration places and increased the number of participants to a level much greater than had been foreseen. The final number of registered voucher holders was 8.56 million citizens. **This massive scale of participation -- nearly 3/4 of all eligible citizens -- was quite unexpected.** The large number of participants was an extreme test of the capacity of the established Center for Voucher Privatization and its computer networks to function on a large scale.

TABLE 5 Structure of Funds in the First Wave, Based on Size of Fund		
Size of Fund (investment points)	**Number of Funds**	**Share of Total Points**
Over 100 Million	13	(Top ten funds: 40 %)
10-100 Million	65	
5-10 Million	43	
Under 10 Million	313	
Total	**434**	**72 %**

Source: Hospodarske Noviny, May 22, 1992.

Intermediaries in Voucher Privatization -- Investment Privatization Funds (IPFs)

An important role in the demand side of voucher privatization has been played by the recently established IPFs. These are funds organized as joint-stock companies, which are allowed to collect voucher points from the public and invest them during the voucher privatization. Some of the funds were purely private, some were established by still state owned banks or joint-stock companies. By the end of the registration period, there were over 430 IPFs registered by commercial courts and the Ministry of Finance.

The significance of the role of the IPFs is tremendous. In the so-called "zero wave," during which voucher holders were able to entrust their points to the various Investment Privatization Funds, 5.8 million people (over 2/3 of those involved in the voucher privatization) chose to designate all of their one thousand investment points to IPFs, and a further 420,000 allotted part of their points to IPFs. In total, IPFs received 72% of all vouchers in circulation, about 6.13 billion investment points (see table 5).

Together, the ten largest IPFs control about 40% of all investment points and about 56% of all points that were allocated to IPFs. The largest fund, Ceska Sporitelna, controls over 800 million points. The other largest funds are the funds of Komercni Banka, Investicni Banka (Czech and Slovak branches), Ceska and Slovenska Pojistovna, Slovenska Sporitelna, Vseobecna Uverova Banka, Creditanstalt, Zivnostenska Banka, and Harvard Capital and Consulting (the only non-banking institution among the largest funds). Only 78 funds gained more than 10 million points. In general, future shareholders appear to have put most of their faith in traditional monetary institutions, which have a wide network of affiliates and large advertising capacity. These institutions also have the largest number of financially trained experts, although it remains to be seen whether or not they have enough know-how to oversee the acquisition of property worth "billions".

Until the late (April 28, 1992) passage of a law regulating IPFs there was very limited regulation for IPFs, given only by the rules regulating establishment of IPFs (as joint-stock corporations) or by ad hoc governmental decrees. These rules provided only very weak regulation, and this problem was widely criticized (see Mejstrik, Kyn, et.al.). The principles included into the Law on Regulation of IPFs -- a disclosure rule, diversification requirements, prevention of conflicts of interest, rules regulating operation, etc. -- were not

Table 6: Project Submission and Approval, by jurisdiction, Czech Republic	Firms under jurisdiction of Ministry of:				Firms under Local Government/ Municipality	Other**	Total
	Economy	Trade	Industry	Agriculture			
Total Projects, Wave 1	759	1116	4353	2967	1605	491	11291
Total Projects, Wave 2	982	716	1640	1019	4	104	4465
Total Firms, Wave 1	199	237	1067	644	524	105	2776
Total Firms, Wave 2	93	83	461	285	3	13	938
Wave 1 Projects Reviewed	573	809	3210	2249	908	325	8074
Wave 2 projects Reviewed	185	152	172	100	2	6	617
Total Projects Approved	136	141	736	433	233	64	1743
Property Approved (bil. Kcs)	37.1	22.2	241.0	106.6	20.1	21.0	448.0

** The category "Other" includes the Ministry of Health Care, for which only a small number of projects have been submitted so far, but for which many projects will be submitted in the near future due to a later deadline.

Source: Karel Cermak, Czech Republic Ministry for Privatization applied in time. Usually a full prospectus of an IPF, with full disclosure of its capital stock, personal history of members of the board of directors, and description of operational charges, is not widely available. In fact, it was disclosed that many IPFs had appointed to their boards of directors governmental officials who sometimes play important roles in the voucher privatization procedure. Finally, the April 28, 1992 Law on Investment Funds and Corporations addressed this issue.

PROGRESS TO EARLY 1993

As of early January, the Czech Republic Ministry of Privatization reported having evaluated just over 8,596 of the roughly 11,300 projects submitted in the first wave, of which nearly 2,000 had been approved, creating over 3,900 new business units (see Tables 6,7). For nearly each state-owned enterprise, two new private companies were created, which served to increase competition and encourage restructuring the assets for commercial, productive use. This still left about 2,700 first-wave privatization projects in front of the Ministry. The Ministry was also just getting under way in evaluating second round projects, of which it had received nearly 5,600. Further projects expected from the health care sector had not yet been received.

The Schedule for the First Wave of Privatization

ROUND	Start	Deadline for Point Allocation	End of Round
"Zero" round	Mar.1, 1992	Apr. 26	May 15
First round	May 18	June 8	June 30
Second round	July 8	July 28	Aug. 18
Third round	Aug. 26	Sept. 15	Oct. 6
Fourth round	Oct. 14	Oct. 27	Nov. 17
Fifth round	Nov. 23	Dec. 2	Dec. 22

Source: Kuponova Privatizace 2, Nos. 6,7,8,9, and 10.

TABLE 7: Approved Privatization Projects in the Czech Republic, First Wave (January 19, 1993)				
Approved Method of Privatization	**Number of Bus. Units**	**Share of Units**	**Total Value of Property (million Kcs, 28 Kcs=$1)**	**Share of Property**
A: Public Auction	336	8.60	3902.1	0.80
B: Public Tender	308	7.88	10924.2	2.25
C: Direct Sale	1005	25.72	25955.3	5.35
D: Commercialization into joint-stock structure	1028	26.31	289523.7	59.65
E: Privatization of an already existing state owned joint-stock company	191	4.89	130670.1	26.92
F: Unpaid Transfer to municipalities, pension funds, banks, or savings banks	1040	26.61	9688.7	2.00
Voucher Privatization (out of D and E)			238041.4	49.05
Property to be Returned to Original Owners			765.8	0.16
Property Partially Written Off as Unusable			10621.8	2.19
Remaining Value of Assets Partially Written Off			1621.7	0.33
Property to Small Privatization			1325.5	0.27
Expected Earnings on Auction of Stocks			343.9	0.07
TOTAL (Total number of projects = 1,968)	**3908**	**100.00**	**485342.8**	**100.00**

Source: Karel Cermak, Czech Republic Ministry for the Administration of State Property and its Privatization

The Slovak Republic had received about 1,500 projects on 736 firms in the first wave, of which 430 were approved for the first wave of voucher privatization. By late November, projects had been approved for 874 economic subjects of total value 165.3 bil. Kcs. Of those, 188 were approved for direct sale, 20 for public auction, 10 for public tenders, 7 for restitution, 95 for unpaid transfer, and the remaining 544 were directed to voucher privatization. First-wave projects which involve voucher privatization but were approved too late for the first wave of vouchers will be included in the second wave of voucher privatization.

At first, most of the projects that were approved involved vouchers, simply because both republics hurried to evaluate voucher projects earlier than other projects in order to fulfil their quotas for voucher privatization (see table 4). More recently, however, the shares of other means of privatization, especially direct sale, have been increasing (see table 7).

As for foreign participation, from the first wave of privatization, there have been negotiations with 220 potential foreign investors in the Czech Republic. The total book value of assets involved in these negotiations is almost 50 billion Kcs ($1.7 billion). By mid-1992, 50 deals had been closed with 15 billion Kcs ($.5 bil.) of investment. Considering that the book value of these properties was only 8 billion Kcs, the potential for inflow of foreign capital in the remaining 170 properties -- which employ 100,000 workers and encompass about 40 billion Kcs ($1.4 bil.) in book value -- is quite likely to exceed the estimated book value. A special group of expert advisors, supported by USAID, has been assisting the Czech government in negotiations with potential foreign investors. Foreign participation is significantly smaller in the Slovak Republic. Foreign investment realized in the CSFR from January through October 1992 totalled 27.6 bil. Kcs ($975.8 million), with investment in the Czech Republic, accounting for 92% of all foreign investment. Foreign investment accounted for more than half of the income generated for the Czech National Property Fund in 1992.

The **first wave of voucher privatization** has for the most part been completed -- all investing has ended and participants have been informed of their acquisitions with the actual transfer share ownership to the new shareholders having taken place in April 1993. The second wave started in the summer of 1993 in the Czech Republic, slightly later in the Slovak Republic. It is expected that the Czech Republic will offer over 100 billion Kcs worth of (book value) property in its second wave of voucher privatization. The second wave is being run separately in the individual republics and the Slovak Republic does not plan to give priority to the voucher scheme as a means of privatization.

Table 8: Supply and Demand for shares (mil. shares, 1 share valued at 1,000 Kcs of book value)	ROUND				
	1	2	3	4	5
Supply of shares (book value)	299.4	210.0	132.1	99.6	62.5
Demand for shares	235.7	148.2	273.9	106.8	47.4
Demand by IPFs	175.2	92.5	122.2	53.4	20.8
Demand by Individuals	60.5	55.7	151.7	53.4	26.55
Sold to IPFs	69.9	50.6	19.6	17.0	18.83
Sold to Individuals	19.5	27.2	12.9	20.0	22.12
Sold in round	89.4	77.8	32.5	37.1	40.95
Cumulative total sold	89.4	167.4	199.8	236.9	277.8
% of total sold	29.9%	55.8%	66.9%	79.1%	92.8%

Source: Kuponova Privatizace 2, No. 8-10.

Overall, 277.8 million of the offered 299.4 million shares were "sold" for vouchers in the first wave. Only 100 mil. voucher points of the 8.54 bil. registered were not invested successfully. Thus, **92.8% of all shares offered for vouchers were transferred and 98.8% of all investment points were invested successfully in the first wave of voucher privatization.** Of the 1491 firms involved, only 291 sold 100% of the shares which they offered for vouchers, but over half of the rest sold over 90% of shares offered.

The first round of the first wave started on May 18th, 1992. Because the value of property going into the first wave of voucher privatization was approximately 35,000 Kcs/coupon book, the price of all shares was initially set at 3 shares per 100 voucher points (100 points is the minimum investment in any given firm, the value of each share is 1,000 Kcs -- $35). This value was chosen because stock splits are not allowed, and thus a rate of 3.5 shares would not be possible, and because to undervalue the vouchers (rather than to overvalue using a rate of 4) would ensure that citizens would not be left with extra voucher points at the end of the wave. This undervaluing, at a level of about 15% of the value of vouchers, has been maintained throughout the process, however, which means that the Funds of

National Property in the respective republics will end up with a significant number of shares in their possession even if 100% of investment points are invested.

Citizens and IPFs invested during the first round until June 8th. The rate of participation was very high -- over 90% of all points "invested" (see table 9) -- and has continued to be very high (in individual rounds, from 88-93% of available points used to place orders) throughout the process. Of course, many attempted investments had to be returned due to oversubscription of firms -- almost 65% of voucher points invested had to be returned to investors due to oversubscription. Nevertheless, overall 30% of shares were sold in the first round (see table 8). Share prices were then adjusted by a special price-setting committee appointed by the Federal Ministry of Finance.

By the end of the second round almost three-quarters of investment points had already been successfully invested but only 56% of all shares had been sold. In the second round, only about 30% of voucher points invested were returned to investors due to oversubscription. Once again, share prices were adjusted where necessary -- the minimum

Table 9: Voucher points used (bil. points)	ROUND				
	1	2	3	4	5
Points remaining available	8.54	5.55	2.14	1.13	0.62
Points used to order shares	7.86	4.88	1.99	1.00	0.56
% of available points used to order	92%	88%	93%	89%	90%
Satisfied demand	2.98	3.40	1.02	0.51	0.52
% of orders satisfied	34.9%	69.7%	51.3%	51.0%	92.9%
Cumulative satisfied demand	2.98	6.38	7.40	7.91	8.44
% of total points successfully invested	35.4%	75.0%	86.8%	93%	98.8%

Source: Kuponova Privatizace 2, No. 8-10.

price was reduced by nearly 10 times for the third round -- and by the end of the third round 67% of all shares had been sold (only 11% of total shares were sold in the third round, as opposed to 30%, 26% and over 12% in the first, second, and fourth rounds) and over 85% of all voucher points used. At the end of the fourth round in November, 79% of all shares had been sold and 93% of all available voucher points had been used. In the third and fourth rounds, the percentage of investment points returned to investors due to oversubscription was roughly 49%.

Out of the total 278 billion Kcs worth of property sold, IPFs obtained 176 billion and individual investors 101.8 billion. Thus, IPFs control 66.3% of total book value offered for this wave of voucher privatization. The quality and fair market price of shares controlled by IPFs, in comparison with those obtained by individuals, is unclear. By the second round, it became clear that individual investors responded very strongly to price changes, whereas IPFs changed there behavior less, since their judgments were based on other criteria, as well as on price. Judging by the third wave, in which individual investors were attracted by extremely low prices to invest more heavily in the firms which had previously been of little interest, it is likely that the IPFs have invested in higher quality shares while individuals have tried to maximize the book value obtained for their investment points. **The IPFs, which had 72% of voucher points and control only 66.3% of the property being privatized (i.e. they have invested in the shares which cost more voucher points).**

There were only a few difficulties with the adjustment of share prices by the pricing committee of the Ministry of Finance (see table 10 for minimum and maximum share prices). Prices diverged from the first round, where all prices were set the same, to the second round, where the ratio of highest price to lowest was 40:1. In the third round, this ratio reached 776:1. It appears that in the third round prices were lowered too greatly for some firms which the committee feared would not be of interest to investors because little interest had been shown in the first two rounds. These firms were subsequently largely oversubscribed in response to their low prices. In the fourth round, the ratio of these rates decreased, to 600:1, where it remained for the fifth round.

Table 10: Firms in Voucher Privatization and Prices of shares	ROUND				
	1	2	3	4	5
Firms offering shares	1491	1443	1369	1317	1236
Firms oversubscribed	421	439	507	369	117
Undersubscribed	1022	930	811	868	1079
Sold	48	72	51	80	40
Total Sold	48	120	171	251	291
Minimum share price (shares:points)	3:100	10:100	97:100	60:100	60:100
Maximum share price (shares:points)	3:100	1:400	1:800	1:1000	1:1000

Note: Four firms have been excluded from voucher privatization for reasons other than complete sale of shares (e.g. significant decrease in the calculated basic value of the firm)

Source: Kuponova Privatizace 2, No. 8-10.

By the end of the fifth round the vast majority of investment points were successfully invested. In order to ensure the highest possible rate of success in fulfilling orders by the end of the wave, the Center for Voucher Privatization requested that in the fifth round investors repeat the orders which they made in the fourth round. Thus, the pricing commission set prices for the fifth round that would equilibrate supply and demand based on fourth round orders so that a maximal share of orders would be fulfilled. As mentioned above, because of the undervaluing of the coupon books, the Funds of National Property ended up with a fair amount of property in their hands, totalling 21.55 million shares.

Although few firms out of the original number were 100% sold (291 out of 1491 -- see table 10), many firms have only a small number of shares remaining unsold. The next task will be to allow the new owners of these firms to start influencing firm behavior as soon as possible. Until the issuance of shares, the owner of all firms is still technically the Fund of National Property. This situation is less than ideal, considering that firms would like to start operating under their new owners' influence, the Fund of National Property cannot possibly handle the management of tens of hundreds of firms while it is also responsible for the organization of auctions and tenders and other aspects of the privatization program, and the IPFs, who have been operating for a year with no revenue, would like to start governing the enterprises whose shares they hold in order to start improving the quality of their assets.

By early 1993, some IPFs had already started clamoring for their ownership rights, and had even started to do something about getting control of the firms in which they are part owners. In several cases, IPFs have grouped together and met with firm management in order to start determining a business strategy for the future. Some IPFs have already appointed their representatives to managing boards of companies whose shares they have acquired (or through coalitions with other IPFs), and these representatives have in some cases been able to change firm strategy or propose a new management. Although the Fund of National Property was still technically the owner of these firms, it had given this practice its blessing.

In general, Czech IPFs and investors invested almost exclusively in the Czech Republic. Czechs bought a total of 6.3 million shares of Slovak enterprises, while Slovaks bought 22.0 mil. shares in Czech firms. Czech investment in the Slovak Republic ranged in the first four rounds from 1.8% to 4.1% of total successful investment by Czech investors, rising to 7.7% of investment in the final round, when investors looked to less desirable firms in order to use all of their points. Slovak IPFs invested more heavily in the Czech Republic, while individual Slovak investors also showed an interest in Czech firms, although smaller than the interest shown by IPFs. In the fifth round, Slovak individuals placed 13% of their orders in the Czech Republic, while **orders by Slovak IPFs in the Czech Republic were a full 38% of their total orders. In the first round, Slovak IPFs had placed 47% of their total orders in the Czech Republic.** In the various rounds, Slovak investors overall invested from 17.5% to 28.6% of total successful investment in the Czech Republic.

Recently, since the first wave has ended and Czechoslovakia has split into two nations, the Czech Republic Ministry of Privatization is clamoring for compensation from Slovakia to make up for the imbalance in property transferred between republics in the voucher process. The Ministry is calling for full compensation of the book value of the net transfer of property between the republics, amounting to roughly 19 bil. Kcs ($650 mil.). The Slovak side has so far refused this demand, claiming that voucher privatization was always conceived as a federal procedure and the rules should not be changed now, and pointing out that the existing Law on Division of Property does not address this issue. As a compromise, the Slovak Ministry of Privatization has offered 800 mil. Kcs ($28 mil.) from its restitution fund, an offer rejected by the Czech side. Further negotiation will be necessary in order to resolve this issue, although the Czech Ministry has already suggested that legal changes could be enacted to prevent the transfer of shares to Slovak investors who had obtained them in the voucher process.

Problems of the Large Privatization

There are many problems which have been associated with the large privatization process. On the supply side, they are often related with the quantity and quality of submitted privatization projects and the difficulty involved in writing them. On the demand side of voucher privatization, they are mostly related to the lack of regulation on IPFs and the inadequacy of currently existing institutional structures. In general, the voucher privatization has suffered from a lack of foresight in regulation. Nonetheless, in the case of Czechoslovakia, where the top levels of government were committed to the concept of mass privatization and supported by the public in this commitment, the desired results appear to have been achieved. For the second wave a more secure system should be in place (see below).

It is important to note that despite problems encountered, **the Czechoslovak voucher privatization process has been run in a highly sophisticated and well-organized technical manner, especially considering its huge scope of activity.** This level of performance may be difficult to achieve in other reforming nations due to the lack of communications facilities, computer networks available and the general level of market awareness of citizens and of professionals involved in the process. The whole process has also been supported by the general public's confidence in the enterprises being privatized, an important factor which has not been so visible in many other reforming nations. The sophisticated computer network, used by the Center for Voucher Privatization and the registration places, may be difficult for other nations to reproduce and has played a pivotal role in the whole procedure. In fact, after the end of voucher privatization, existing databases and networks will be used for the Center for Securities, which will maintain share accounts for the new shareholders from voucher privatization on the new stock exchange.

It is also worth noting that the administrative costs of voucher privatization were completely self-financing. Initial costs of setting up computer networks and the registration places were covered by loans, which were repaid using proceeds from sales of voucher booklets and stamps. The unexpectedly high rate of registration even led to a slight surplus.

Problems with Privatization Projects and Evaluation

The case-by-case privatization process requires the evaluation of firms' market value, which is not easily established, given past pricing systems, inadequate benchmarks of value and poor accounting systems. The process of evaluating market value is also costly. The market value of the firm might, of course, be equal to zero for a poor asset (with low expected cash flows etc.) or be many times greater than the book value for a good asset (esp.for internationally competitive firms). To assess the market value of the firm from expected cash flows on the basis of historical and current product and input prices (based on domestic individual costs and mark up combined with nontransparent subsidies) is somewhat naive. Hence modifications of common evaluation procedures are required case by case to indicate potential (international) competitiveness of the firm.

Under existing conditions of trade expressed in book value, citizens are often wary of foreign buyouts, as there are accusations that the national heritage is being sold off too cheaply.

For privatization projects involving foreign investors in the Czech Republic, the USAID advisory team has reviewed and carried out independent valuations using a multitude of methods, ultimately setting a basis for price negotiations.

Many competing projects have proposed the break-up of existing large enterprises. For the most part, this is a positive development, because of excessive horizontal integration of Czechoslovak SOEs. Break up also allows the creation of a currently nacient segment of small- and medium-sized firms. Unfortunately, in many cases competing projects are trying to divide something which is technologically indivisible. On average, each approved privatization project has led to the creation of about two new business units.

Many projects presented weak or poorly elaborated business plans. In addition, due to time constraints and lack of qualified staff, the Ministries of Privatization have had great difficulty in comparing and evaluating these business plans as a part of the decision-making process in evaluating privatization projects. For those SOE privatization projects involving foreign investment, the USAID advisors assisted the Ministry of Privatization to review and negotiate all of the projects for that SOE.

Management's Role in Privatization

It is beyond doubt that firm management had a great degree of control over the whole privatization process. Given that management had an information monopoly for the elaboration of privatization projects, and that the managers are naturally the most familiar with the condition and productive capacities of their firms, it can be argued that firm management has more or less controlled the privatization process, even though management was required to provide information to the competing bidders.

Often, management of enterprises refused to deliver (or delivered very slowly) information necessary for other parties interested in developing competing projects. This conduct was made legally punishable by the amendment to the Law on Large Privatization, which was

TABLE 11 ELABORATORS OF APPROVED PRIVATIZATION PROJECTS (Jan. 19, 1993)		
Author	**Number of Projects**	**Percent of Projects Approved**
Total Projects Approved	1,968	100.0 %
Enterprise Management	1,267	64.4 %
Management of Individual Plants (Subordinate Management)	109	5.5
Interested Buyer	386	19.6
Original Owner	53	2.7
Ministry	10	0.5
Consulting Firm	36	1.8
Local Privatization Council	37	1.9
Other	45	2.3
Local Founding Institution	16	0.8
Trade Union	1	0.1
Not Listed	8	0.4

Source: Karel Cermak, Czech Republic Ministry for the Administration of State Property and its Privatization

passed in February 1992. In fact, this strategy was successful for some company managers, considering that almost two-thirds of projects approved so far have been those submitted by enterprise management (see Table 11). This number was much higher than the 25% of all projects originally submitted by enterprise management (see Table 3). Many of these projects proposed management buyouts of the enterprise.

Management of state-owned firms often took advantage of its position to strip (i.e. to sell off) assets to cover operating losses and provide themselves with increased income. In one technique, managers were able to set up parallel companies and use transfer prices to sell products at low prices to the private companies which they owned, thus transferring large profits to themselves. These practices could even in some cases lead to bankruptcy of the state-owned company, which could then be cheaply acquired by the new, liquid private company.

A loophole in privatization legislation allowed existing management to sign long-term rental agreements, which de facto predetermined the fate of the property before privatization. This loophole was addressed by the amendment to the law on privatization.

Many firms entering privatization have inherited heavy debts from the past (e.g. due to distorted price structures), creating a weak initial financial structure for privatization and an obstacle to the formation of feasible business plans. Moreover, since the process of privatization has taken many months, management "waiting for new owners" may have acted with little restraint, causing the debt burden to increase further during the interim (see below).

All of these factors put together meant that in many cases, managers of state-owned enterprises were able to elaborate proposals that allowed them to take over ownership of their firms through management buy-outs and buy-ins. In many cases, these were managers who had been appointed after the revolution of 1989, and often very capable individuals. Although in some cases managers were able to exploit their position in the privatization process, in the end the large number of management buy-outs and buy-ins may turn out to be a positive development from the stand point of creating viable, successful enterprises, since these may well be the people most qualified to be governing the privatized firms under local conditions, especially given the limited number of qualified managers in the nation.

Problems in Privatization Procedures and Rules

Because the privatization process in Czechoslovakia (as elsewhere in the region) was an unprecedented process, many rules and procedures were not thoroughly defined beforehand. Although the procedure has run somewhat smoothly, it is important to acknowledge that the procedure of learning-by-doing required some changes in mid-course, which have resulted in certain costs. In addition, sometimes it has been unclear under which jurisdiction certain activities have belonged, leading to problems for evaluators and potential investors. Following are some problems caused by unclear or changing regulations.

- Constant changes in legislation during the transition period (e.g. new commercial code) were not reflected in the first wave privatization projects, which therefore needed some time for adjustment.

- The "mother", supervising branch ministries also had to review the projects and their conclusions were sometimes at odds with those of the Privatization Ministries, often supporting existing management. In fact, the inherited hierarchy and coalitions were still largely in place, although this situation is gradually changing.

- Selection procedures and rules were not prepared in time and there may not have led to a consistent, transparent means of evaluating projects. Some rules do exist; for example, in cases where there are two or more competing projects, competitive forms of privatization (e.g. public auction, public tender) are preferred over direct sales to predetermined buyers. Decision makers are under permanent time pressure as well as lobbying pressure from various groups with vested interests. The new conception formed for the second wave has made the process of project evaluation and approval more objective.

Foreign capital participation is seen as an important contribution to the development of Czechoslovakia's industry. Nonetheless, foreigners were often discouraged by the tangled web of negotiations which had to be undertaken in order to participate in privatization. Given the standard process, it was quite likely that foreigners would have to negotiate with enterprise management, then with branch ministries, then with the Privatization Ministry and its USAID advisers. The problems of this protracted process were addressed, at least to some degree, by the new conception of privatization brought in after the June elections (see below).

The creation of Investment Privatization Funds (IPFs) and Funds of National Property (FNPs) has had several consequences within the framework of the privatization. Some of these problems are due to the inability of the new organizations to start functioning optimally, some due to the lack of regulatory framework for their activities. One of the major problems is the transfer of ownership away from the FNPs, interim holders of the shares of all firms being privatized.

The newly created Funds of National Property of the Czech and Slovak Republics serve as temporary owners of privatized property. These funds implement decisions made at the Ministries, including decisions on enterprise contracts and the composition of enterprise Boards of Directors, as well as organizing privatization activities such as auctions and tenders. By the end of 1992, the Czech FNP had implemented only about 40% of the approved privatization projects forwarded to it by the Ministry of Privatization, leaving a large amount of property remaining in the hands of the FNPs.

A significant number of shares will remain in thc FNPs' hands after the voucher privatization. It is not yet clear how the FNPs will privatize this property, and whether they will be able to participate actively as owners of the firms in which they hold shares.

Laws concerning the establishment and regulation of stock markets in Prague and Bratislava were passed in April 1992. Whether these markets will be able to function effectively by June 1993, when they are expected to commence operation, is still quite questionable.[3] There will also be trading through the so-called RM system, based on computer networks

[3] For more information about the new stock markets, see CERGE Reform Round Table Working Paper No. 6, "Stock Markets in the CSFR," 1992.

and databases inherited from voucher privatization, which can provide some opportunities for trading to begin smoothly.[4]

The law regulating the behavior of IPFs was not passed until April 28, 1992, after IPFs had completed gathering investment points from citizens (some problems with the IPFs were elaborated above). This law does provide needed guidelines on diversification of risk and on general disclosure. The law also requires that by the end of 1993, IPFs must adjust their operations to become real investment funds, which may reduce their ability to function efficiently in the short run. Later in 1992, further changes in requirements for IPFs came into effect as a result of the law on investment companies.[5]

Given the high option offers that were made by the IPFs, it is possible that some will face bankruptcy when these options mature. This is especially true because the average book value of assets per coupon book was almost 70,000 Kcs ($2,300) when the IPFs began making their offers, but because more than twice as many coupon books were registered before the registration deadline, this figure has fallen to around 35,000 Kcs ($1,100) per coupon book. Some bankruptcies in the IPF sector could have a negative effect upon the economy. The new law on investment funds may alleviate this problem by recognizing open and closed funds, the latter of which are not obliged to fulfil their promises. At least part of the concern about this issue was alleviated by a recent poll which revealed that there is in fact an increasing demand for the shares of some funds, which could compensate for those who choose to cash in their shares. In fact, Harvard Capital and Consulting has offered to begin to redeem its options for cash even now at a rate discounted from its original offer by the actual nominal interest rate, but response has been quite limited because experts generally believe that on average the books are worth over ten times their original value.

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[4] For more information on the functioning of the RM System, see article by Dusan Trinka in Privatization Newsletter No. 9, November 1992.

[5] For details, see Privatization Newsletter No. 11, December 1992.

It is still unclear how active a role shareholders will have in the corporate governance of the IPFs, which have been controlled by their founders until now. Currently, the only way that shareholders can act is to sell of their holdings. For IPFs which are owned by a large, fragmented group of voucher holders, it seems unlikely that the new shareholders will be able to group together to influence fund management.

Fine Tuning of the Conception of Privatization: The New Privatization Ministers and the Second Wave of Privatization

In both the Czech and Slovak Republics, new Ministers of Privatization were appointed as part of the formation of new governments which took place after the June 1992 elections. Both new ministers promised to address a "lack of definition" which had generally plagued the privatization process. In each republic, this involved a clearer definition of which privatization methods would be given priority, more transparent methods of choosing between projects, less bureaucratic entanglements and less room for use of personal contacts in getting proposals approved.

One of the major questions to be resolved was the manner in which the resolution of the nation's future would influence the course of privatization. With regard to this question, the two ministers arrived at two important conclusions: the first wave would be completed and its results would be respected; and the second wave should be carried out separately by the individual republics.

The first decision, that the results of the first wave would be respected, resulted from several factors. Perhaps most important was that to alter the first wave in any way would further delay the transfer of enterprise ownership into private hands, a result which was seen as unacceptable. A further factor in determining that the first wave would continue unchanged was the respect for the rights of shareholders who have already obtained shares. According to this original agreement, any legal measures which may have to be enacted (i.e. governing foreign ownership of shares after the federation separates and Czechs and Slovaks each own significant numbers of shares in the other nation) would have to be taken in such a manner that they would not infringe upon the rights of those who are already shareholders of firms. However, as mentioned above, the Czech Ministry of Privatization has already gone back on this agreement, pointing to the fact that Slovaks would benefit disproportionately if no compensation is provided for the Czech property which they obtained in the first wave.

The second decision, that the second wave of voucher privatization should be conducted separately by the two republics, resulted from the conclusion that a united privatization process could eventually be held up by legal obstacles when the federation breaks up. Under the existing privatization mechanism, it should not be difficult to undertake the second wave on a republican, rather than a federal, level. Furthermore, it is felt that the voucher privatization is a transfer of something of significant value to the population. Therefore, in the case of national separation, there should be no reason why either republic's government should want to make such a transfer to foreign citizens.

The two republican privatization ministries worked independently on the formation of their "new conceptions" of privatization. In the Czech Republic, the main emphasis is on a more precise definition of the steps involved in the privatization process. First of all, changes in the approval process are being made to resolve differences between the Ministry of Privatization and other Ministries involved in the evaluation of privatization proposals. Disagreements which formerly were resolved by the Economic Council of the Government will now be addressed by a special interministerial Government Privatization Commission. This policy change will clarify the overall process, while also simplifying procedures for foreign investors, who will deal with representatives of several ministries through the Commission, rather than having to scramble between the various ministries.

A second important change in the Czech Ministry's conception of privatization is the approach to standard privatization methods. For smaller firms (book value under 50 million Kcs, $1.7 mil.), standard methods will have priority. The use of direct sale as a means of privatization has been criticized because much of the population does not see it as a fair means for the transfer of property. Thus, the ministry has decided upon several conditions. In cases where only one proposal is submitted and it proposes direct sale, it can be approved only if the price offered is greater than the book value of the assets. Where several proposals are made, those suggesting competitive methods (i.e. auction, tender) will have priority. When several proposals are made, all of which propose direct sale, then a non-public competition will take place in which all project submitters may bid, and the deciding criteria will be price. In the past, the ministry had tried to rely on several criteria, but practice revealed this method to be non-transparent and difficult to administer.

Slovak officials have described their new conception of privatization as a "step toward transparency." The main developments which it will entail involve an increased reliance on standard methods -- mainly public tender and competitive methods -- and a decrease in the overall significance of the voucher privatization scheme.

FUTURE DEVELOPMENTS

New private owners have already taken over in the cases of many privatized firms, especially those privatized through direct sale. The Funds of National Property are feverishly working to organize public auctions and tenders to privatize firms in this manner.

Once shares are in the hands of shareholders, they can be freely tradeable on the stock market or through the use of RM System, a center for off-market stock trading which uses the system of registration places inherited from the voucher privatization scheme. All records of share ownership will be kept in a Center for Securities, which will operate using the computer database from voucher privatization. The RM System is intended to allow anyone to conduct his or her own share trading, rather than forcing them to rely on brokers. It is still unclear, however, how effectively the stock market and the RM System will be able to function together.

Another potential problem is that of the financial risks of the IPFs. Having promised large pay-offs to their shareholders within a year, some of these institutions could be driven into bankruptcy due to the illiquidity (and/or unexpectedly depressed prices) of their shares, again possibly resulting in a chain effect that could severly depress the overall stock market.

CONCLUSIONS ON CMPP

The most important observation to make about the privatization process in Czechoslovakia is that it is well under way and that it has been successful. The privatization is seen as extremely important part of reform package and is supported both by the public and by parliament, an important consideration in assuring that the process maintains its momentum. One of the important political goals has been to ensure that the process did not get mired down in details or in controversies about its problems.

The CSFR's privatization program, now divided into separate programs of the Czech and Slovak Republics, has been the most unique part of its reform strategy. In addition to more than 100,000 restitution claims settled, over 30,000 small firms were auctioned in small privatization and 4,000 out of 6,000 large firms are being privatized in the first and second waves of large privatization, which should be completed by mid-1994. In the privatization process, foreign participation is also encouraged, and amounted to $600 million in 1991 and $950 million in the first three quarters of 1992.

As far as the problems of privatization can be judged, it is clear that there have been many. But no process of such large-scale economic change can be problem-free. Several problemsand loopholes were addressed by the amendment to the Law on Large Privatization. The most important policy pursued within the large privatization was the promotion of competitive privatization bids, allowing various offers including the voucher system and also direct sales, public auctions and tenders, and other means of property transfer. This policy, however, altered the process from its originally conceived voucher form by adding traditional case by case sales privatization, and caused many unforeseen problems which required immediate attention.

Perhaps the greatest problem of the large privatization has been the lack of a firm legal framework. The effects of changes in regulations have been to make the rules of the game unclear for potential investors and other project submitters, and for the organizers of the IPFs. In spite of this problem, however, the first wave of vouchers has been completed and the majority of first wave projects have been evaluated (although not yet implemented). The second wave will be able to learn from the lessons of the first, and thus have a much sounder foundation for operation from its beginning, not suffering as much from the government's frequent changes in policy.

The major issue for the near future is the problem of exercising of new property rights. As mentioned above, this problem came to the forefront in some cases where privatization of certain firms had already been approved or achieved through vouchers, but where legal obstacles prevented the new owners from taking control quickly.

3. POLAND'S MASS PRIVATIZATION PROGRAM

In Poland, there is great interest in developing equities markets, particularly given the dependence of current privatization plans on effective means for raising and trading equity. Currently, the stock market has little quantative significance in the economy: trade equities are held by by a small fraction of the population, and the total market value of the 16 firms listed on the Warsaw Stock Exchange in early May 1993 appears to be about zl 7 trillion, or only 0.5 percent of the GDP. Since may 1992, the Ministry of Finance has also issued some zl 5 trillion of one- and three-year Treasury bonds at floating rates of interest that are now traded (in minimum blocks of about $6,000 equivalent) on the Stock Exchange.

The Polish Mass Privatization Program (PMPP), enacted by Parliament in April 1993, will substantially broaden ownership of equities and the need for equity trading among the general public. Under this program, up to 600 medium and large-sized SOEs (financially viable companies with annual sales of not less than $5 million per year) will be privatized into widely held companies. As a group, the 600SOEs to be included in the PMPP have a book value of about zl 150 trillion ($8 billion). The PMPP will involve distribution of most of the equity of each company to National Investment Funds (NIFs, 60 percent of the total) and to employees of the enterprises (15 percent).

Approximately 20 NIFs -- each of which will constitute a closed-end mutual fund and will have its own Wetsern-Polish investment management company -- will be established and their sahres listed on the Warsaw Stock Exchange by 1994. About five of the NIFs will be founded for the benefit of several million government employees and pensioners who will receive free share certificates (to compensate for past inflation). The other NIFs will be founded for the benefit of all adult citizens who choose to purchase Universal Share Certificates for an amount of to 10 percent of the monthly wage. With the NIFs listed on the stock exchange, both of these groups will have a fairly broad market on which to dispose of or trade such shares.

However, most of the underlying 600 vompanies will not be eligible for listing on WSE. In particular, the requirements for companies to be listed on the Warsaw Stock Exchange are sufficiently stringent to preclude WSE listings for most of the newly privatized companies that will emerge during 1993-1994 under the PMPP or through debt-equity swaps to be initiated through the enterprise and bank restructuring program. Accordingly, the tens of thousands of company employees of PMPP enterprises who receive direct bearer shares in their companies during the fall of 1993 will need some informal or organized (for example, over-the-counter) market for trading of their shares.

Rules and facilities for an over-the-counter market do not yet exist in Poland, and in view of the unprofitability of Polish brokerage firms at present, it is doubtful whether an efficient over-the counter market can quickly emerge without some type of official direction or sponsorship. In developing such a market, it is importyant to ensure that officially sanctioned trading is accompanied by adequate disclosure requirements to protect investors.

Poland's legal and regulatory infrastructure for the stock market seems to be rather highly developed (for examply, defining clearly the property rights of share holders and requiring a three-year financial history and extensive disclosure of information). The capacity of the Securities Commission for investigation and enforcement of sanctions against misconduct is untested.

The mass privatization program in Poland (PMPP) envisages the privatization of some 600 large SOEs, utilizing National Investment Funds (Funds) as a primary vehicle for restructuring those SOEs. Polish citizens would be the majority shareholders in the Funds through the conversion of master share certificates into the Funds. The share certificates, a form of voucher, would be distributed, first, to pensioners and civil servants (with deferred wage claims) and, second, to all Polish citizens permanently residing in Poland 18 years of age or older. Eventually the Funds would be listed on the Polish Stock exchange, a step that would significantly deepen the capital market and the participation of Polish citizens in the transformation.

The PMPP is important to the Polish privatization program and the overall reform. This group of large SOEs are the ones that are currently profitable but are expected to perform better under new professional management that the IPF, will provide.

The Debate Over the Polish Mass Privatization Program

The PMPP has followed a long and difficult path. In contrast to Czechoslovakia, where Prime Minister Vaclav Klaus and those in favor of fast-paced reform have held power from the beginning, the PMPP has had inconsistent support within the government, has been largely resisted by organized labor, and has failed to mobilize public support. Moreover, Polish managers had already "spontaneously" privatized a number of the large SOEs during the socialist reforms in the late 1980s.[6]

The Polish privatization program always envisaged mass privatization, inclusive of citizen shareholdings. The Parliament initially endorsed this concept, in the debates leading up to the adoption of the Law on Privatization of State Owned Enterprises on July 13, 1990. Both domestic and external advisors to the government had commented on and written extensively about this program throughout 1990.[7] By the end of that year, the MOP had made mass privatization one of its primary privatization alternatives and had adopted a clear approach to privatizing an initial tranche of 200 enterprises within 10 investment Funds, with vouchers to be distributed to the population at large for conversion into these Funds.[8]

During the first quarter of 1991, the MOP hired professional advisors to design the voucher system, conceptualize and design the structure for the Funds, develop an off-market trading system to accumulate and intermediate vouchers, and prepare the legal materials for mass privatization, including eventually an information memorandum for interested Fund managers, a Fund Manager Agreement, a Draft Performance Agreement, Statutes on National Investment Funds, and a draft law--Statutes of MPP Companies--that would govern mass privatization and the Funds. By the end of 1991, the investment advisors had solicited

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[6] See Andrew Berg, "The Logistics of Privatization in Poland," chapter 4, Ph.D. dissertation ______________, Harvard University, Cambridge, Mass., October, 1992, p. 147, with respect to spontaneous privatization.

[7] See J. Lewandowski and J. Szomburg, "The Strategy of Privatization," The Gdansk Institute for Market Economics, No. 7, Gdansk, 1990; Polish Ministry of Finance, "A Plan for Citizen Ownership in the Polish Privatization Process" (mimeo), July 29, 1990; Joseph C. Bell, "Social Privatization: Vouchers Vs. Funds" (mimeo from an advisor to L. Balcerowicz, Minister of Finance, Kryzystof Lis, Minister of Privatization, and Stefan Kawalec, Ministry of Finance), September 1, 1990; *first name* Lipton and *Jeffrey* Sachs, "Privatization in Eastern Europe: The Case of Poland," Brookings Papers on Economic Activity, Spring 1991. The latter paper describes what Sachs and Lipton had advocated for some time as advisors to the government.

[8] See Government of the Republic of Poland, "Program for the Privatization of the Polish Economy" (mimeo), Warsaw, December 1990.

interest from prospective Fund managers in financial capitals around the world. By the fall of 1991, the design was largely complete, and it was anticipated that implementation of the MPP would begin in early 1992. Based on the progress made through the fall of 1991, the World Bank approved substantial funding for the PMPP as part of a loan to support industrial restructuring and privatization. In a policy letter to the World Bank the government committed itself to implementing the PMPP as a condition of the loan.

During the run-up to the parliamentary elections at the end of 1992, the Minister of Industry pushed the formation of a powerful Ministry of the Economy that would combine the Ministries of Industry and Privatization, with the Minister of Industry at its head. As part of this effort, she bitterly attacked the entire privatization program, particularly the PMPP. This attack helped undermine the consensus for the program within the government at the most critical stage.

The elections of 1991 resulted in a fragmented Parliament with strong factions, (including within the governing coalition) that opposed the PMPP. Faced with this situation, the acting Minister of Privatization under the new government, Dr. Thomas Grurszecki, who had replaced one of the earliest and strongest advocates of the PMPP, Minister Lewandowski, had to modify the PMPP in the first half of 1992, eventually submitting a draft law on the PMPP to the Parliament in August 1992. After a surprise defeat of the MPP in March 1993, the government substantially revised the formula for distribution of shares, which led to passage of the law in April 1993.

The problems with the PMPP show that privatization is above all a political process. Governments that build a consensus for their program, as well as for other important economic reform measures, will succeed in the long term.

Design of the Polish Mass Privatization Program

The PMPP has six major components: (a) formation of the Funds to manage and restructure a group of SOEs; (b) selection, commercialization, and allocation to the Funds of approximately 600 large SOEs that meet the criteria for the PMPP; (c) distribution of share certificates (vouchers) to the Polish public to build support for the privatization program; (c) off-market trading and conversion of the share certificates into the Funds; (d) flotation of the Funds on the Warsaw Stock Exchange and market trading of the shares of the Funds so as to deepen Poland's capital market; and a public information and publicity campaign to educate the public about the program.

National Investment Funds

A selection panel established by the MOP will choose the Fund managers. An initial marketing effort resulted in expressions of interest from over 100 potential Fund managers from Poland and throughout the world. An initial group of 20 with demonstrated experience will be selected using transparent bidding criteria established by the ministry and applied to all the Funds. The government will license the Funds and clearly delineate prudential practices and limits on Fund activities. Fund managers will operate the Funds under management agreements. Fee structures establish a fixed fee for managers plus an incentive based on the capital appreciation of their Funds. Initially the State Treasury will own the Funds. However, after the SOEs are allocated to the Funds (discussed below), an initial period of operation, and the first year's audit of the Funds (some 18 months after their start-up), the share certificates owned by Polish citizens will be converted into shares in the Funds, and the Funds will be floated on the Warsaw Stock Exchange. This step will create publicly quoted and traded closed-end mutual funds. In year four of their operations, the Funds will have the option of converting to open-end mutual funds. In short, the structure is a classical one in which Fund managers establish management companies and operate the Funds according to a management agreement that clearly defines the compensation arrangements, cost reimbursements, authority, and responsibility.

The Funds themselves will be organized as joint stock companies, with all the shares owned by the State Treasury until it issues its shares to the public. The Funds will operate with a dual board of directors structure. A Supervisory Board will be made up of Polish citizens, initially to be appointed by the Treasury and thereafter by the shareholders at the annual shareholders' meeting. The Supervisory Board will appoint a Management Board, whose chairman must be a Polish citizen. In the beginning, the Funds will be the lead shareholders in 20-30 enterprises (owners of 33 percent of the shares in these enterprises) and owners of a passive share in all the converted enterprises.

The Polish public will become investors in the Funds via conversion of their share certificates into all or some of the Funds, depending on their investment strategies. Brokerage firms and other intermediaries such as cantors (foreign exchange dealers) will be utilized to establish off-market trading and accumulation of share certificates so that the Funds are not overwhelmed by millions of certificates. In accordance with the anti-monopoly laws, there will be strict initial limits on individual ownership of a Fund so that no single investor or affiliated group of investors can corner one.

The advantages of the Fund scheme proposed for the PMPP are as follows:

- formation of investment funds managed by firms or consortiums with established investment expertise should provide a vehicle for restructuring, initial governance, valuation, and eventual stock market flotation or other exit strategies. In other words, groups able to evaluate the restructuring requirements of privatized enterprises and to make the firms more competitive will exercise initial governance. Moreover, the Fund managers will have incentives to maximize the value of their holdings over time.

- the Fund managers, who will have internationally recognized credentials, are more likely to attract direct foreign investment to Poland, which in turn would mean fresh capital, technology, and market access to the firms held by the Funds.

- initially the Funds will hold a diversified portfolio of firms so that failure of any one or even a few holdings is unlikely to pose any jeopardy. Polish citizens will benefit in terms of risk diversification in any given Fund, and to the extent they spread their share certificates across Funds their risks will be spread further.

- trading of the Funds' shares will immediately deepen capital market activity.

- Fund managers are likely to want to establish other fund products in Poland, such as cash funds and bond or fixed income funds, the result being a further diversification and deepening of the capital market.

The success of the PMPP depends a great deal on the quality of the intermediaries selected to manage the National Investment Funds and the willingness of enterprise management and workers to accept the intermediaries' role in guiding and restructuring the enterprises.

Selection of Enterprises for Mass Privatization, Commercialization, and Ultimate Privatization

Selection of the SOEs for the PMPP has always been somewhat problematic. From the beginning the Polish privatization program sought to use diverse approaches to privatization including: **liquidation**, which essentially amounts to employee buy-outs of small- to medium-size distribution and manufacturing enterprises; **trade sales**, including stock market flotations and direct sales to foreign and domestic investors; **sectoral privatization**, which involves sales of enterprises based on a mandate to financial advisors to focus on a specific sector such as cosmetics or detergents and to generate transactions within that sector; **contracting out**, with privatization resulting from contract management and restructuring of the SOE; and **mass privatization**.

Each approach has merits. It is not, however, clear why certain firms have ben designated for one privatization stream versus another. The divisions of MOP have always vied to sequester enterprises for one method versus another, a competition that has contributed to an undesirable inventory of firms awaiting privatization in the midst of a vacuum in governance. Of particular concern has been the failure to link sectoral privatization to the PMPP.

During 1991, the ministry selected some 200 SOEs from the larger group to enter the PMPP. These firms were medium-size to large by Polish standards, with minimum sales of US$10 million; they were presumably viable, profitable, and not excessively leveraged. Together they represented some 10 percent of the annual sales of the industrial sector and some 8.5 percent of employment. With the assistance of two of the major international accounting firms and local consultants, the ministry prepared an information memorandum on each of the firms and collected financial data in a data base, all of which was to be made available to the managers selected for the Funds. Each of the firms has been commercialized (transformed into a joint stock company). While the financial information has been updated regularly, it is unclear how many of the firms still meet the original criteria.

Complicating the selection of firms for the PMPP is the social or labor pact, which was not resolved before dissolution of Parliament in May 1993. The government has sought to reduce the militancy of labor and the number of strikes by reaching an accommodation with Solidarity over the reforms. While the draft terms of the pact are confidential, reportedly a six-month period will be designated during which the labor councils in each SOE will be able to select their preferred method of privatization. After this period, if the council fails to reach a decision, the MOP could commercialize the firm and presumably allocate it to the PMPP.

Ownership of the firms at the time of allocation to the Funds will be as follows: 33 percent to a lead Fund; 27 percent spread across a group of Funds; 10 percent to employees; and the balance, 30 percent, to the State Treasury. Of the state's 30 percent, 18 percent is to be allocated to cover the pension and civil service wage liabilities incurred by the government, and presumably some percentage would go toward restitution if the Parliament passes the draft bill on restitution. At this point the ownership distinction is somewhat artificial, as the

State Treasury will be the ultimate owner of the Funds until the citizens' share certificates were converted into Fund shares, to take place some 18 months after the first allocation.

At the start, each Fund will be limited to only a 33 percent holding in any individual SOE. Once the on-line trading begins, however, the Fund managers will be able, subject to the guidelines of their supervisory boards, to buy and sell shares or companies for their portfolios as they deem appropriate. At various trigger points, for example, at a 10 percent, 20 percent, 33 percent, 50 percent, 66 percent, or 75 percent shareholding in a firm, the Funds will have to notify the anti-monopoly agency and the Securities Commission of the intent to purchase.

Share certificates (vouchers) will be given to pensioners and civil servants (who are being compensated for past caps on pensions and wages. Other share certificates will be made available to all Polish citizens 18 years and older residing permanently in Poland as of December 31, 1992, upon payment of a modest administrative fee for their share certificates.

Capital Market Development

The off-line trading of share certificates and the eventual listing of the Funds on the Warsaw Stock Exchange should lead to an important deepening of Poland's capital markets. If the initial process goes well, it is inevitable that the Fund managers will seek to diversify their product offerings. In addition, within a relatively short time the Funds will seek to buy and sell blocks of shares to modify their portfolio holdings and eventually to float some of the newly privatized enterprises on the stock exchange. The Funds should attract both active and passive foreign investors.

Public Information Campaign

Although the PMPP has been fiercely debated, the government has done little to educate the public at large about the program. The MOP recognizes that it needs to undertake a substantial public information and publicity campaign to promote the privatization program and share certificates (vouchers).

Implementation Capability

A critical feature of this program will be the MOP's ability to implement it. The MOP has set up a quasi-independent agency, the Privatization Center, to handle implementation. It has an experienced chief executive officer, senior Polish and advisory staff, and external advisors in the legal, investment banking, accounting, and consultancy areas, who in addition have been with the program from its inception.

4. CRITICAL ISSUES IN A MASS PRIVATIZATION PROGRAM

Portfolio Analysis: The Selection of Firms to be Privatized

The issue of selection, or *segmentation*, pervades every aspect of a mass privatization program. The Czech and Slovak Republics and Poland have a vast portfolio of SOEs to privatize, while some will remain as public enterprises. Experience around the world shows that no one method or technique of privatization is applicable to every enterprise. Early on the PMPP set up a rich menu of privatization alternatives, although the rationale for designating sets of firms for one alternative versus another has never been clear. Implicit in the Czech and Slovak program, on the other hand, is the view that virtually all large SOEs will (in some degree) be part of the mass privatization. However, the program does give firms the right to establish their own privatization plans and allows competing plans to be put forward to keep the process "honest." Different privatization alternatives have emerged, such as direct sales, auctions and tenders, and voucher sales. It could be said that in the end the Polish and Czech and Slovak programs have converged in this area. An important difference between the two is that the CMPP has secured strong popular and enterprise commitment. This commitment has yet to emerge for the PMPP.

Preparation for Privatization: Governance and Restructuring

The literature on economic reform in Eastern Europe assumes that corporatization and the imposition of a hard budget constraint will improve corporate governance and that the former SOEs will automatically begin to operate autonomously and independently from government intervention. Above all, it has been assumed these firms would respond to economic reforms and emerging market signals, start to restructure, and become more efficient. A further assumption is that they would eagerly embrace privatization.

These assumptions have not been borne out. Among the many reasons are such diverse factors as the lack of competition, rigidity of the labor markets, restrictions on foreign investment, importance of the social services provided by the SOEs (which include child care, health care, vacations, sports facilities and even meals), an unwillingness to change management that will not adapt, and the refusal to allow non-viable firms to exit the market so that resources can flow to more productive areas of the economy.

Pro-Competition Policy

Both the CMPP and the PMPP have been cognizant of the problems their inherited industrial structures create for competition and the creation of a real market economy. The Czech and Slovak program deals with this issue to some extent by prior review and approval by the government of all privatization projects submitted. The Polish program, on the other hand, relies on a number of post-privatization checks on the activities of the Funds and acquisition of shares in private enterprises. Trigger points require notification of the anti-monopoly agency of proposed purchases of a certain share in a firm or of acquisition of a firm. Presumably, SOEs selected for the PMPP have been screened as to monopolistic structures, although the program does not address this point explicitly.

Environment

An important issue in privatization in Eastern Europe and the CIS is the problematic environmental legacy of socialism. For some types of enterprises, liability for past environment sins could lead to a situation of negative net worth for that enterprise even though "current operations" may be viable. The Czech and Slovak program deals with this issue in two ways:

- The government has agreed to assume some of the historic environmental liabilities. Some portion of the residual shares remaining in the National Property Funds of the republics as well as a portion of the cash received from SOE sales will be used to pay for these contingent liabilities.

- Some enterprises were allocated to municipalities for privatization to cover the cost of environmental clean-up in their areas.

The PMPP for the most part tries to skate around the issue of environmental liability. The government has generally taken the position that it will not accept liability for or give representations on the environment. While mass privatization is basically a matter for the federal government (republics in the case of Czechoslovakia), environmental issues are basically dealt with on a local or regional basis. Therefore, environmental problems may loom as an open issue for the newly privatized firms, as the local authorities seek to enforce environmental standards. The main counter balance to these environmental risks that the Polish MPP enterprises were originally screened to be relatively profitable companies.

Financial Intermediation

Both the Czech and Slovak and the Polish privatization models assign an important role to financial intermediaries. For its part, the CMPP is very market-driven and laissez-faire. The government strongly encouraged intermediaries but did not initially foresee a need for much regulation or prudential supervision. Initially it was also assumed that the intermediaries would be domestically formed groups. In fact, major foreign fund groups, such as a subsidiary of Creditanstalt of Austria and a subsidiary of Credit Commercial of France, have taken on a role, alongside major domestic financial institutions. Despite the large number of funds that initially formed to collect vouchers, in excess of 400 firms have formed to intermediate vouchers. However, 10 Funds ended up with 40 percent of the Czech vouchers.

In contrast, the Polish model is highly defined, with the financial intermediaries at the center of the system. Intermediaries are an essential part of a mass privatization program, particularly in terms of their role in interim governance of newly privatized firms and in having their own NIF shares become tradable deepening the incipient capital markets. An international investment bank and a consortium of foreign and Polish lawyers worked with the MOP to define the nature of the Funds, related statutes and regulations, and a draft contract for the prospective Fund managers. The investment bank has solicited participation in these Funds in capital markets throughout the world, testing its views and concepts against initial market reactions. While the government has received formal bids, it has not acted on them pending negotiation of final management contracts with the Funds.

In Poland, the goal is to establish some 20 financial intermediaries in the next couple of years, all managed by well-known, world-class firms and all actively traded on the Polish stock exchange. The key is to use these investment management funds in the initial stage as "turn-around" funds and thereafter to float their holdings on the stock exchange or otherwise divest the fund of the assets.

VOUCHERS

Vouchers in Practice

Although mass privatization schemes and vouchers are not inevitably linked, they are generally associated. Most Eastern European countries and some in the CIS have proposed vouchers to speed up the privatization and assure a more fair and equitable distribution of the wealth previously held by the state. Vouchers in the form of certificates or scrip are distributed to the population; holders can convert them into shares in SOEs through some form of auction. Czechoslovakia, Lithuania, and Mongolia are following this approach. In the Polish and Rumanian cases, holders of vouchers (or share certificates in Poland) will convert their shares into investment management funds, which in turn will own an interest in and manage a portfolio of SOEs.

In Czechoslovakia citizens can convert their vouchers into shares directly at auctions or indirectly by turning them over to Funds that in turn bid for shares in enterprises. In Poland voucher conversion is limited to the investment funds, although the vouchers are tradable and can be sold off-market for cash. In Czechoslovakia some 8.5 million citizens have paid a nominal subscription fee to obtain vouchers; in Lithuania voucher subscription was virtually universal, as the vouchers could be used to purchase apartments. Hungary will limit its vouchers to restitution.

The Complexities of Voucher Schemes

Design of a voucher scheme and the associated system for auctioning enterprises to voucher holders is very complex, requiring a series of decisions that all affect cost and complexity. Some of the key decisions are noted below:

- issuance of one or a series of vouchers, tied to the auctioning of firms in a series of tranches

- whether to value the vouchers and make them bearer or nominative governs controls and security printing

- issuance at the national or regional levels

- institution(s) to use to control the physical issuance or distribution of vouchers, for example, the voter registration system, savings banks, or the social security or pension systems

- what rules, if any, to establish to govern the trading of vouchers

- the role of financial intermediaries in accumulation of vouchers, how the intermediaries will be registered, regulated, and supervised, and the linkage to the development of capital markets and prudential regulation of financial institutions

- conversion of vouchers into shares via an auction system for share registration and trading

- use of vouchers as a medium of exchange for alternative purposes to buy shares, land, apartments, etc., versus what restrictions to place on vouchers

- linkage of the vouchers to the distribution of preference shares to employees--will the vouchers be additive or will they be utilized as a way to distribute these preference shares to employees

- computer and accounting control systems for the vouchers--will they be developed for alternative usage such as share registration and trading.

INSTITUTIONAL SUPPORT FOR MASS PRIVATIZATION

The demands of mass privatization are likely to be such that substantially greater institutional support will be needed once the process gets underway. In Poland one role of the Privatization Center is to attract talented Poles and external advisors paid at an acceptable rate. The ministry hired external consultants to advise it on the organization of the Center, to prepare job descriptions, and to analyze additional support requirements. The program has been supported by external professional advisors--investment bankers, lawyers, accountants and consultants--throughout.

In Czechoslovakia the MOP (rather than gpvernment salary scales) acknowledged the need for support when it opted to pay Czech advisors at market rates so that the ministry could retain them for the duration of the process. The reason is that in Poland and Czechoslovakia the attrition rate of ministry staff paid at civil service rates has been high and has jeopardized continuity of the programs.

LESSONS LEARNED ABOUT MASS PRIVATIZATION

Mass privatization fits the unique requirements of Eastern European countries and those of the former Soviet Union, where production was totally concentrated in the state sector (in excess of 90 percent of production in some countries). The Czech and Slovak and Polish programs are potentially important demonstration cases because of the very different ways in which they have developed.

Mass privatization is an intensely political process requiring top-down commitment at the highest political levels. Failure can rarely be attributed predominantly to technical reasons. Czechoslovakia, as an example, has been able to maintain the momentum of its privatization because of top-down political leadership at the highest levels. In contrast, the Polish PMPP was stalled for two years by political conflict. Moreover, in Eastern Europe, special problems such as indemnities have threatened to derail privatization because of a lack of clarity over property rights.

Given its scale, mass privatization demands intensive technical assistance support--from investment bankers, strategic consultants, lawyers, accountants, public information advisors, and environmental specialists. Most of these advisors will need to be recruited from outside the country with support from national counterparts, particularly at the regional and municipal levels. Delays in providing such assistance increase the risks of failure.

The privatization ministries have the enormous responsibility of divesting billions of dollars worth of state property under difficult economic circumstances. In light of the scope of this task, they are very underfunded and poorly staffed. Given prevailing government salaries, it is common that staff are hired away by the private sector, particularly by foreign firms, which offer salaries several times those of the government. Arrangements are needed that allow qualified staff to be recruited on terms equivalent to what the private sector offers and to contract out as much of the implementation as possible. The Polish MPP seems to provide a good model for contracting out at the stage of operation of the investment funds.

Public information (public relations and mass communications) is vital to educate the public about privatization in general and specific issues such as vouchers and investment funds. There is also a need to link privatization in the public's perception to the overall reform program and the transition to a market economy. The Central and Eastern European countries have invariably understood this need belatedly and have rarely had the funding to carry out such a program.

The approach to privatization should be bottom-up and decentralized. The Czech and Slovak program has proceeded on the basis that the enterprises should be responsible for preparing their own privatization programs. Meanwhile, the population also has felt strongly involved in privatization to the fullest extent possible through voucher distribution. Because the Czech and Slovak program puts maximum emphasis on private initiative, it has obtained commitment at all levels. After initial delays, almost 2,000 firms are being privatized in the first wave, and another 2,000 are slated for 1993.

A final lesson is that structural change and adjustment pursuant to and following privatization will be a long, drawn-out process in the Central and Eastern European countries. Even where mass privatization occurs and the process is accelerated, it is clearly recognized that privatization is only the first phase of structural reform. Extensive restructuring will need to follow, and assuredly ownership structures will change substantially after the initial tranches of privatization. With greater access to foreign contacts industry knowledge Privatization needs to be viewed as part of comprehensive reform programs. It would be a mistake to expect too much from privatization itself.

VI. CONCLUSIONS: LESSONS LEARNED

This study of the privatization programs of Hungary, Czechoslovakia and Poland showed that while there are common elements, the programs have developed in very different ways with varying results. While each of the countries had similar tools at their disposal, these differences can be traced to the heart of each program, the objectives of each country's privatization program and how the tools were used to meet those objectives. In Czechoslovakia, where the stated objective was simply to privatize quickly, top priority was given to this objective and techniques were developed to ensure that this objective would be met. In Hungary, where the government sought to achieve a number of objectives simultaneously, such as privatizing quickly and maximizing proceeds from the sale of its SOEs, a conflict was created which slowed the process. In Poland, the general desire to privatize was sincere, however, competing objectives for the privatization program quickly emerged amongst several groups which slowed the Polish process because each privatization required negotiating and establishing its own set of priorities, such as ownership distribution, safeguarding employment or attracting new investment.

Below is a brief synopsis of the common elements arising out of this comparative privatization study with respect to internal privatization, mass privatization and corporate governance, and some of the lessons which have been observed. These elements represent a challenge to both the host country governments and to the donor agencies in their efforts to promote the development of market economies. After each challenge is discussed, specific measures are presented through which the governments and the donor agencies can help overcome these challenges.

Privatization has Strong Political Ramifications

Privatization is an intensely political process requiring top-down commitment at the highest political levels. Failure can rarely be attributed predominantly to technical reasons. Czechoslovakia, as an example, has been able to maintain the momentum of its privatization because of political leadership and support at the highest levels. In contrast, the Polish MPP has been stalled by the political fragmentation that, until recently, halted parliamentary approval of the program.

Largely for political reasons, internal privatization is by far the most prevalent method among completed privatizations in the three countries for medium and large enterprises. The reasons for this include: the relative ease of the process, the bottom-up participation of management/workers, and the absence of foreign participation. Because of a widespread feeling of antipathy towards foreign ownership of enterprises, the absence of foreign participation in these internal privatizations greatly speeds the process. However, this trade-off may be more costly in later stages of restructuring when technical and managerial skills, and capital, are in short supply.

The initial negative public reaction to the perceived unfairness of internal privatizations appears to have subsided. The process has become more institutionalized to allow for a greater degree of transparency. The bottom-up approach of allowing companies and regional officials to develop proposals before submission to central authorities works reasonably well, although one drawback is the lack of knowledgeable and experienced officials at the regional level.

The concept of mass privatization as a means to equitably, widely and quickly distribute ownership among the citizenship fits the unique requirements of East European countries and those of the NIS, where production was totally concentrated in the state sector. Mass privatization programs are found at the core of many of the privatization efforts in these countries. The Czech and Slovak and Polish programs are potentially important demonstration cases.

Host-Country Measures

The approach to mass privatization should be bottom-up and decentralized so as to gain the widest possible base of support. The Czech and Slovak program has proceeded on the basis that the enterprises should be responsible for preparing their own privatization programs and that the population should be involved in privatization to the fullest extent possible through voucher distribution. In Czechoslovakia, funds formed spontaneously have not been operating long enough to determine their actual viability as financial intermediaries in assistance of this process. Also, because the Czech and Slovak program puts maximum emphasis on private initiative, and after initial delays, almost 2,000 firms are being privatized in the first wave, and another 2,000 are slated for 1993.

Small scale privatization has proven to be the first step in the transformation to a market economy. The example from Poland is that small-scale privatization creates the basis for a vibrant commercial and services sector. It makes consumer goods and foodstuffs available to the consumer, and it eventually moves toward privatization of wholesaling, distribution and transportation. It is the easiest way for the population to realize that a market economy and privatization can bring substantial improvements to the standard of living.

Public information (public relations and mass communications) is vital to educate the public about privatization in general and specific issues such as vouchers and investment funds. There is also a need to link privatization in the public's perception to the overall reform program and the transition to a market economy. The Central and Eastern European countries have invariably understood this need belatedly and have rarely had the funding to carry out such a program.

Donor Agency Measures

Donor Agencies could make efforts to foster an appreciation for the benefits that can accrue from developing an open economy. Efforts in this area would help reduce the antipathy towards foreign investments in the countries' economy. Such efforts must be directed not only towards government officials, but towards the populace at large, which has the most to gain or lose from the transformation of the economy.

One note of caution. The "easier" aspects of privatization (such as the sale of the more attractive state enterprises) have progressed, leaving the more difficult tasks such as defense conversion. Political attitudes have also shifted towards greater nationalism. Donor agencies must carefully evaluate the extent to which they can and wish to become involved in the difficult enterprises where more extensive layoffs and liquidation of enterprise assets will be required.

The Financing of Privatization is a Challenge

In all three countries, the pricing of enterprises is based in part on book value. The method allows for simplicity and transparency, but the result is often above what a discounted cash flow or a comparable company/transaction approach would determine. As such, the major problem many internally privatized companies experience at the outset is a lack of cash flow. This difficulty was present through mid-1992 in almost every company examined.

Financing mechanisms to assist the initial internal privatizations have been developed to a limited extent in each of the countries by government bodies. Yet little, if any, financing is available from financial institutions without extremely high levels of collateral, which typically these companies (or their new owners) cannot meet.

Internal privatization is difficult to accomplish in larger enterprises or those which are capital intensive. The amount of financil capital that can be generated by the workers/management is typically too low. In addition, this method does not provide any infusion of foreign management and technical skills that are usually required for the larger, more capital intensive enterprises.

Host-Country Measures

All countries embarking on privatization have realized that it must proceed in tandem with reform of the financial sector. Before embarking on new lending to enterprises, banks in all three countries have moved to reform the credit allocation mechanisms (formerly centralized) that had weakened the banking systems of the former socialist regime. Moreover, countries in transition such as Poland and Czechoslovakia are having to deal with the build-up of inter-enterprise arrears, a problem that may have lead to undesirably wide financial distress in both the enterprise and banking sectors. Poland is recapitalizing its banks and restructuring their portfolios, with World Bank, and other donor assistance. Direct financial linkage to privatization has not been established in Poland; SOEs seeking debt forgiveness as part of the privatization will have to commercialize as part of their preparations.

Donor Agency Measures

Donor Agencies can be helpful in this area by providing expertise on the banking sector -- both that which improves credit allocations to viable new ventures and that which can help the banks force restructuring or liquidation of viable old enterprises. Such expertise is generally lacking in Eastern Europe

Privatization Does Not Necessarily Improve Corporate Governance

Privatization has generally had little effect on corporate governance in the absence of a dominant (foreign) shareholder even though managers have shown considerable willingness to adapt to their new circumstances. Interim governing bodies, such as the SPA, that have no interest in the going concern but rather in maximizing revenue to the state, may be more likely to take short term decisions that have a negative affect on the efficiency of an enterprise. This is important in those SOEs that cannot be sold rapidly. Many managers of state enterprises see their future employment and careers linked to the success of their enterprise, but they need the business tools to make this a reality. The governments, however, do not have the funds to provide this breadth and depth of training.

Host-Country Measures

Objectives for the privatization program and guidelines for participation in the program must be clear. Any trade-offs in major objectives, such as maximizing revenues by waiting to sell an entire enterprise rather than selling it in pieces to ensure the going concern of the viable portion of the enterprise, needs to be articulated clearly to those involved. Seeking active participation of key managers and directors in coordination with privatization officials makes the process more efficient. Host countries must also allow the establishment of compensation schemes that provide the appropriate incentives to both shareholders (governance) and management (corporate performance).

Donor Agency Measures

The critical shortage of qualified managers and directors can only be addressed quickly through massive education and training efforts, which none of these countries are able to afford. This is a key area for donor agency support.

Privatization has Social Ramifications

Privatization programs need to take into account the adverse social impact associated with enterprise restructuring, which is likely to lead to large-scale layoffs, sometimes in geographic areas where the enterprise is the main source of employment. The spin-off of non-productive social assets currently supported by all large SOEs in the region is likely to have an adverse social impact. Failure to deal with these issues risks derailing the privatization program.

In Central and Eastern Europe, special problems such as indemnities have threatened to derail privatization. All of the privatization programs have had to deal with the problems of land ownership and restitution. Further derailment is threatened by the absence of proper business support structures, including legislative and regulatory frameworks, to allow privatized businesses to operate commercially in a stable environment. This takes into account the absence of efficient energy supplies, adequate telecommunications and modern banking systems.

<u>Host-Country Measures</u>

The governments of the countries experiencing such problems will have to deal with them decisively, or run the risk that public backlash will derail the transformation process. Countries which have never before had to deal with large scale unemployment will now need to develop safety nets that are less expensive and better targetted than those inhereted from the socialist era.

Donor Agency Measures

The most obvious way donor agencies can help the host countries is by providing assistance to help build the necessary improved social safety nets. Since the host countries face severe budgetary constraints, financial assistance from the donor agencies would be invaluable in this area.

Environmental Issues Present a Challenge

Environmental problems may loom as an open issue for the newly privatized firms, as the local authorities seek to enforce environmental standards. While some major foreign investors may be willing to take on responsibility for past environmental damage, the financial resources of domestic acquirors are unlikely to be sufficient for them prudently to accept such responsibility.

Host-Country Measures

In selling businesses, governments will need to recognize that they may have to continue to retain the contingent liability for remedying past environmental damage that has not yet come to light. The Czechs and Slovak governments, recognizing this need, have agreed to assume historic environmental liabilities. Some portion of the residual shares remaining in the P operty Funds of the republics will be used to pay these contingent liabilities. They have also allocated some enterprises to the municipalities for privatization to cover the cost of environmental clean-up in their area. The Hungarians established an environmental protection center with foreign assistance to help prevent further environmental damage, but the responsibility for existing liabilities typically falls to the buyers as it does in Poland.

Donor Agency Measures

There has been extensive work throughout the West on environmental regulation and remediation. Technical assistance for creating realistic compliance structures both in connection with privatizations and for the private sector in general, as well as for preliminary clean-up should be provided.

Privatization is a Drawn-Out Process

A final lesson is that structural change and adjustment pursuant to and following privatization will be a long, drawn-out process in the Central and Eastern European countries. Poland, Hungary and Czechoslovakia have missed all of their early self-imposed deadlines. Even where mass privatization occurs and the process is accelerated, it is clearly recognized that privatization is only the first phase of structural reform. Extensive restructuring will need to follow, and assuredly ownership structures will change substantially after the initial tranches of privatization.

Host Government Measures

It is crucial for host governments to learn from those countries which have implemented privatization programs. Particularly, it is important to set goals and clear objectives, and to manage expectations by not setting overly ambitious timetables. Privatization is not the cure for all of the economic problems created by central planning and it must be considered within the larger context of economic and political reform. To benefit from privatization, these economies must also undergo a restructuring of their industries and other key economic sectors to make the system function efficiently.

Donor Agency Measures

Donor agencies can help in a number of ways. First, they can coordinate among themselves to ensure the optimal use of scarce technical assistance funds. Second, they can educate the top levels of government about the privatization experience of other countries, through high level symposia and facilitating a dialogue among the practitioners and soon-to-be practitioners of privatization. Third, donor agencies can provide the expertise needed to evaluate the needs and plan the structures necessary, including new legislation or agencies, for undertaking massive privatization efforts. Fourth, they can provide hands-on experts to assist in the evaluation of privatization projects.

APPENDIX A

Czechoslovakia

Privatization programs in Czechoslovakia are being implemented under laws and governmental decrees adopted in 1990, as well as under the relevant aspects of a more comprehensive economic transition program that came into effect on January 1, 1991.

The privatization process has three principal elements: wide-ranging reprivatization (restitution) measures, a small scale privatization program, and large scale privatization. The main body of legislation includes:

> Act No. 298/1990 - On Regulations of Property Relations of Religious Orders and Congregations and the Archdiocese of Olomouc
>
> Act No. 403/1990 - Mitigation of Property Related Injustices
>
> Act No. 87/1991 - On Out-of-Court Rehabilitations (the Large-Scale Reprivatization Law)
>
> Act No. 229/1991 - On Regulation of Ownership of Land and Other Agricultural Property.
>
> Act No. 427/1990 - Transfer of State Property and Some Goods to Other Legal or Physical Persons - addresses small scale privatization.
>
> Act No. 92/1991 - On Conditions and Terms Governing the Transfer of State Property to Other Persons - applies to large scale privatization.
>
> Act No. 171/1991 - On the Czech Republic Property Fund - defines legal framework for large scale privatization in Czech Republic.

Other crucial pieces of legislation related to private enterprise, the laws governing bankruptcy, commercial activity and entrepreneurial endeavors were all enacted nearly one year after the principal privatization decrees.

Poland

The following are the most significant laws and regulations pertaining to property rights, forms of business organization, and privatization adopted in Poland:

Arrangement Proceedings Act (1934),

Insolvency Act (1990),

Law on State Enterprises (1981),

Law on Self-Management of State-Owned Enterprises (1981),

Law on Cooperatives (1982),

Law on Foundations (1984),

Law on Economic Activity (1988),

Joint Ventures Act (1988),

Law Governing Changes in the Organization and Activities of Cooperatives (1990),

Law on Land Administration and Real Estate Expropriation (amended in 1990),

Law on Privatization of State-Owned Enterprises (1990) (Privatization Law), Special Regulation of the Ministry of Finance, No. 43, Item 334 (November 10, 1990) - on interest payments on leases under lease and sale arrangements,

Law on Foreign Investment (1991) (Joint Venture Act),

Act on Treasury-Owned Agricultural Property (1991),

Polish Civil Code,

Polish Commercial Code.

Hungary

The following laws were defined in Hungary as the most important pieces of legislation on property rights (including acts relating to privatization) and existing forms of business organization:

Law No. 33 of 1984 on Enterprise Council,

Law No. 1 of 1987 of Lands,

Law No. VI of 1988 on Business Societies, Associations, Companies and Ventures (Company Law),

Law No. XXIV of 1988 on Foreign Investment in Hungary,

Law No. XIII of 1989 on the Transformation of Economic Organizations and Business Associations (Transformation Law),

Law No. VII of 1990 on the State Property Agency and on the Management of State Property in State Enterprises,

Law No. VIII of 1990 on the Protection of Property Entrusted to State Enterprises,

Law No. LXXIV of 1990 on the Privatization, Alienation, and Utilization of State-Owned Enterprises Engaged in Retail Trade, Catering and Consumer Services (Preprivatization Law),

Law No. XXV of 1991 on Partial Compensation for Damages Unlawfully Caused by the State to Properties Owned by Citizens in the Interest of Settling Ownership of Local Governments;

Law No. I of 1992 on Cooperatives,

Law No. II of 1992 on the Entry into Force of Law I of 1992 and the rules of Transition (Cooperative Transition Law).