Review of Economies in Transition
Idäntalouksien katsauksia

1992 • No. 4 13.7.1992

Reprint in PDF format 2002

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Bank of Finland
Institute for Economies in Transition, BOFIT

ISSN 1235-7405
Reprint in PDF format 2002

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# Privatization in Czechoslovakia: Preliminary Report

## 1 The Extent of the Problem

In none of the other smaller European communist countries was the elimination of private property carried out as completely as in Czechoslovakia. Poland had private farming; in Hungary there has always been a private sector, and in the Eighties, private and semi-private companies thrived; even the former GDR retained some forms of private business. In Czechoslovakia, following the nationalization of the largest companies and banks in October 1945, all industrial enterprises were seized by the new communist regime after 1948. In the Fifties, agriculture was collectivized (here, cooperatives were formed; but in most practical respects, this form of property differed only slightly from state-owned property, as in the following decades genuine cooperative decision-making, based on members' property rights, was substantially limited).

By the end of the Fifties, the last and smallest private businesses in retail trade and local services were also confiscated by the state (or their proprietors were forced to form special types of cooperatives). After that, no private enterprise (with the exception of a few private farmers) existed in Czechoslovakia, except as part of the shadow (underground) economy.

The almost complete elimination of private entrepreneurial activity was one of the reasons why Czechoslovakia, once one of the most advanced industrial regions of Europe, was lagging more and more behind in its economic performance. Complete "socialist" ownership formed a firm base for a full-fledged command economy, with highly monopolized production structures. The absence of private activities also enabled complete central price setting and price control, with the result that prices lost their ability to foster the efficient allocation of resources.

In state-owned enterprises or – mostly formal – cooperatives, individual initiative and responsibility was largely lost, as was entrepreneurial know-how. Collective irresponsibility arose. In the social sphere, people became accustomed to relying on a paternalistic state in every way.

The centralization of enterprise profits in the state budget, natural in a state-owned economy, led to huge redistributions – profits were sucked off from where they were made, and used to subsidize loss-making enterprises seen as "needing help".

Productivity growth within the economy has been slowing down since the Sixties, and by the end of the Eighties, productivity actually began to fall (its growth rates were negative). Czechoslovakia was also lagging behind in the technical level and quality of its products, losing ground in international competitiveness, and becoming more and more dependent on nondiscriminating Soviet and other C.M.E.A. markets. These adverse long-term trends have to be changed if transformation to the market economy is to be successful in the longer run.

Rapid privatization of state-owned enterprises is seen as one of the main pillars of transformation – along with price liberalization, liberalization of exports and imports, introduction of partial convertibility of currency and macroeconomic stabilization.

The stress laid on the speed of privatization can only be fully understood if one realizes that there is a fundamental difference between the performance of state-owned firms in market economies, with efficient price structures, competition and market correctives of their activities and in command – or transforming – economies.

In Czechoslovakia, there are about 5,000 enterprises to be privatized. This represents a combined book value of approximately 2,000 to 3,000 billion crowns. Some enterprises will remain in state hands (public utilities and, for the time being, some large enterprises in the mining, energy and steel industries). But the bulk of the economy is to be privatized as soon as possible, in order to foster more efficient use of the existing capital stock. Future prosperity also depends on support of newly emerging private firms (sometimes called "privatization from below"), but with the economy suffering a severe capital shortage, the efficient use of existing enterprises is very important.

# 2 The Choice of Methods: Why Vouchers

The privatization program in Czechoslovakia has been divided into "small" and "large" privatization. Small privatization involves mainly smaller units in retail trade and services as well as some small-scale industrial enterprises. Large privatization involves large-scale enterprises. In both processes, restitution (returning property to former owners) plays a part. The privatization of land is a separate program in which restitution will play a central role and which will not start before 1993. Hence the following discussion will cover only privatization in the non-agricultural sphere.

The combined book value of enterprises to be privatized greatly exceeds the financial means of the Czechoslovak citizens; if privatization were to proceed only on the basis of sales, it could take more than a century (or even centuries). Consequently, non-traditional methods are being utilized. The distribution of investment vouchers among the population results in a give-away transfer of some state-owned property to private hands, as people pay no more than a small nominal fee that covers only the administrative cost of the operation.

Voucher privatization, though, is not the only method used. Small privatization proceeds by sale of the privatized units through public auction. Even within large privatization, the voucher scheme represents only one of the applied methods, along with direct sale through negotiated deals (including with foreign investors or managers), auctions, or competitive bidding. Limited parts of the property can also be transferred to municipal funds, to banks, or sold under preferential conditions to employees.

Within large privatization, privatization projects are prepared by the existing management; any natural or legal person can also submit a competing privatization project, so that on the average, four projects exist for each enterprise (including projects by potential foreign buyers). The winning project is chosen by the respective (Czech or Slovak) Ministry for Privatization; that means that in the end the ministry decides on the actual shares of different privatization methods which will be used. In conflicting cases or in case of very large enterprises, the final right of decision lies with the government.

# 3 Present State and Open Issues

**Small privatization** began in January 1991; by the end of January 1992, more than 23 thousand small enterprises had been sold, for a total sale price of about 25 billion crowns. At present, small privatization is coming to an end. (For more detail see table 1).

Typically, the items sold in small privatization were movable assets and inventories, together with the right to lease the premises for five years. Only in 25 % of cases also real estate has been sold.

Only Czechoslovak citizens were allowed to bid in the first round of auctions (foreigners could participate in the second round, if the unit failed to sell at 50 % of its starting price). Most units were sold in the first round, for a price which was, on the average, 60 % higher than the starting price. The achieved prices suggest that foreign investors have nevertheless been involved as "silent partners".

As small privatization involves mainly retail trade and services, immediate effects were expected on competition in the supply of goods and services for consumers. Clear positive effects, however, have so far been felt solely in large cities, and in some lines of trade only. Some services have almost disappeared (cleaners, small repair shops) and were replaced with souvenir shops, boutiques, or small travel agencies. In smaller towns and villages, supply on the consumer market has actually deteriorated, owing to a breakdown of contacts to the wholesale trade net which is still awaiting privatization and is highly monopolized.

Though effects of small privatization have so far been conflicting, it has fairly broad support among the population, as people expect visible improvements within the next few years.

Table 1. **Small Privatization in Czechoslovakia (January 31, 1992)**

| | CSFR | CR | SR |
|---|---|---|---|
| Approved for privatization (units) | 36,062 | 25,722 | 10,340 |
| Privatized in total | 23,385 | 15,722 | 7,849 |
| by auction | 16,924 | 13,747 | 3,177 |
| by sale | 6,253 | 1,637 | 4,616 |
| by restitution | 208,000 | 152,000 | 56,000 |
| Revenue from privatization (million USD) | | | |
| by auction | 846,500 | 567,300 | 279,300 |
| by sale | 63,600 | 10,900 | 52,700 |

Source: The State Bank of Czechoslovakia

The legal base for **large privatization** was laid in February 1991. (Law No. 92/91 on the Conditions of Transfer of State Property to Other Persons). Unlike in small privatization, the enterprise is typically divested with its liabilities. The process had actually begun in 1991 by direct sale of some large enterprises to foreign investors, by liquidation of some non-viable units, and by preparatory legal steps such as turning state-owned enterprises into joint-stock companies (to make future privatization easier). But the bulk of large privatization will only come, with the first round of voucher privatization scheduled to start on May 18, 1992.

Of about 5,500 large enterprises, some 4,000 are to be privatized within the next five years. (The rest will either remain in state hands until a possible future privatization, or be liquidated.) Of the 4,000 enterprises selected for rapid privatization, about 2,500 are included in a "first wave", to take place during 1992. This represents book value of approximately 500 billion crowns, of which 260 billion is to be privatized though voucher scheme. Voucher privatization can involve the whole of the book value of an enterprise, or only its part, in combination with other methods such as direct sale – depending on the privatization project finally chosen by the ministry.

As has been mentioned, there were on average four privatization projects for one enterprise. For some companies, in fact, there were as many as 20 or 30 different projects, from various bidders. Roughly 25 % of the competing projects were suggested by members of enterprise management, and 40 % by interested buyers outside the enterprise (including foreign investors). It is interesting that less than 1 % of the competing projects came from enterprise trade unions.

By the end of March 1992, decision has been taken by privatization ministries of both republics as to what projects will be realised, which enterprises will take part in the voucher scheme, and with what share of their property.

Since the second half of 1991, wide publicity has been made for the voucher scheme, to arouse public interest and secure sufficient demand for vouchers on the part of Czechoslovak citizens. At first, it seemed that citizen participation would be low; by the end of 1991, situation changed abruptly as a new element appeared on the scene – the so-called investment privatization funds (IPFs).

These funds have originally been proposed by the government with the idea to assist voucher holders, and to reduce their risk by diversification of the investment portfolio. Also, the funds were to take the role of the proprietor which can hardly be played by large numbers of dispersed owners.

Room was provided for the activity of IPFs without sufficient legal constraints being established first; the funds began to make extraordinary offers to citizens to induce them to have their vouchers invested through the fund. These offers included, e.g., a promise to repay in one year, in cash money, 10 to 15 times the sum invested. (For a citizen, the invested sum in fact is only one thousand crowns – the symbolic price for the right to participate in the voucher scheme. For that, he gets vouchers denominated in so-called investment points, their real value depending on a smart investment decision. The average book value of privatized property per participant is 30 thousand crowns; however, for the IPFs it would be extraordinary difficult to repay 10 thousand crowns to each investor in cash in one year's time. The danger is that most citizens do not realize that even a legal contract is no guarantee in case that the fund goes bankrupt.)

Upon these offers, ordinary citizens seemed to realize for the first time that the vouchers represent some genuine property value, and the number of voucher holders grew dramatically: out of the entitled 11.5 million Czechoslovak citizens over 18 years of age, more than 8.5 million registered as voucher holders before the deadline for the first privatization wave.

The bidding for enterprises, or parts of enterprises, to be privatized through vouchers is to take place in up to five successive auction-type "rounds". A so-called "round zero", in which voucher-holders can commit their vouchers to IPFs, began on February 17, 1992, and expired on April 27, 1992. In the first round, to start on May 18, voucher-holders and IPFs will order enterprise shares at given "prices" in terms of vouchers, set on the basis of their book value (i.e. if bids are successful, each voucher will yield an equal amount of book value in the first round).

If there is not excess demand for a given enterprise, orders will be satisfied, and any remaining unsold part of the enterprise will be transferred to the following round where its price will be adjusted downward. If there is limited excess demand (up to 25 %), the enterprise will be divested at the announced "price" if it can be done by scaling down IPFs' bids by up to 20 percent. Individual bids will be given some preference over IPFs' bids in order to simplify the process: thus, it is expected that as soon as individuals' demands are satisfied, it will be possible to auction the remaining enterprises among a few IPFs in a less complicated way. When 97 % of the shares have been sold, the wave will be declared finished; whether this will be achievable within five rounds remains to be seen.

Possible weak points in the process stem from the public's lack of detailed information about the enterprises, the fact that sales will take place at different prices in different rounds, and possibly from over-sophisticated computer system which has been put in place. The Government is attempting to defuse the possibility of voucher-holder resentment by ensuring that all are informed of the rules of the game.

The first wave of voucher privatization should enable a relatively quick privatization of roughly one fifth of the presently state-owned non-agricultural property. Quickness is seen as the main advantage of this method. It puts a distance between the state and the management of enterprises, as well as between enterprises and the state budget. It provides hard budget constraints for the firms, forcing them to seek new strategies and adapt to radically changed situation.

Another advantage is that the vouchers solve the problem of lack of domestic capital for privatization. Moreover, such capital as there exists can then be used to found additional private enterprises and to start new activities.

Voucher privatization also makes it possible to get around the complicated problem of evaluation of the existing state-owned enterprises. It starts from their book value, while equilibrium prices of their assets will gradually emerge during the process of bidding, and market prices can appear as soon as their stock becomes tradeable.

An advantage which is not to be underestimated is the possibility to gain,through the use of vouchers, political support for the whole privatization process, and for transformation as a whole.

As every privatization method, the vouchers also have some disadvantages and involve some risks. Obvious is the risk of loss of political support if anything goes wrong. This involves a whole array of pitfalls, from possible scandals connected with the use of inside information in bidding, up to the danger of disappointment of a large mass of investors if the firms, or the privatization funds, go bankrupt, or fail to provide any profits or capital gains in the nearest future. Low level of information about enterprises (or about the capital background of IPFs) on the part of investors increases this danger.

Another question is to which extent voucher privatization can provide owners with real influence or management. Effective proprietary control is vital for increasing the efficiency of privatized enterprises. In this connection, the danger of wide dispersion of ownership through vouchers has been discussed. At present, however, owing to the activity of IPFs, the opposite might become true: a high concentration of ownership in the hands of several big privatization funds. In any case, it is clear that voucher privatization cannot at one stroke solve the problem of efficient management, lack of organizational, managerial, financial and marketing know-how, and – last but not least – lack of capital. It is also pointed out that instead of encouraging an inflow of foreign capital and know-how, the voucher scheme discourages foreign investors. Here, however, evidence is highly controversial: there are signs that foreign investors may stand behind some of the privatization funds, with intentions to buy, through vouchers, additional stock of enterprises whose parts they are buying directly.

*   *   *

At present, it is difficult to foresee the actual outcome of voucher privatization. It is an unprecedented process, inevitably involving many unknowns. Yet the same is true of the transformation process as a whole, and every privatization method which could be used has benefits as well as costs and risks. In Czechoslovakia – with full awareness of existing risks – fast privatization has been started, to avoid a prolonged agony, inertia and inefficient behaviour of state-owned enterprises.

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