7. Privatization and restructuring.

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

Proponents of mass privatization (giveaway schemes) emphasized speed.

Opponents emphasized economic efficiency and revenue maximization.

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

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

<table>
<thead>
<tr>
<th></th>
<th>Top down</th>
<th>Bottom-UP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Giveaway to insiders</td>
<td>Russia</td>
<td></td>
</tr>
<tr>
<td>To outsiders</td>
<td>Czech republic</td>
<td></td>
</tr>
<tr>
<td>Sales to insiders</td>
<td></td>
<td>Poland (non cash), Hungary (non cash)</td>
</tr>
<tr>
<td>To outsiders</td>
<td>East Germany</td>
<td>Estonia (non cash)</td>
</tr>
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</table>
### Private Sector Share in GDP.

<table>
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<td>40</td>
<td>45</td>
<td>50</td>
<td>55</td>
<td>60</td>
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</tr>
<tr>
<td>Hungary</td>
<td>25</td>
<td>30</td>
<td>40</td>
<td>50</td>
<td>55</td>
<td>60</td>
<td>70</td>
<td>75</td>
<td>85</td>
</tr>
<tr>
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<tr>
<td>Russia</td>
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<tr>
<td>Ukraine</td>
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<td>40</td>
<td>45</td>
<td>50</td>
<td>55</td>
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</tbody>
</table>

Cumulative privatization revenues (as a % of GDP).

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<td>5.3</td>
<td>6.7</td>
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<tr>
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<td>1.2</td>
<td>1.8</td>
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<td>9.6</td>
<td>12.6</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Czech rep.</td>
<td></td>
<td></td>
<td>1.6</td>
<td>2.6</td>
<td>2.8</td>
<td>3.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td></td>
<td></td>
<td></td>
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<td>0.8</td>
<td>1.3</td>
<td>1.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
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<td>4.8</td>
<td>6.9</td>
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<td>11.9</td>
<td>12.3</td>
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<tr>
<td>Bulgaria</td>
<td>0.4</td>
<td>1.5</td>
<td>0.9</td>
<td>2.9</td>
<td>5.6</td>
<td>5.3</td>
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</tr>
<tr>
<td>Romania</td>
<td>0.1</td>
<td>0.4</td>
<td>1.2</td>
<td>2.2</td>
<td>4.1</td>
<td>6.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>0.8</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
<td>1.7</td>
<td>1.7</td>
<td>2.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>0.1</td>
<td>0.3</td>
<td>0.4</td>
<td>0.7</td>
<td>0.8</td>
<td>1.3</td>
<td></td>
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</tr>
</tbody>
</table>

Objectives of privatization:

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

Which one is the most important?

Empirical evidence: matching more important.
Constraints facing privatization policies:

• stock-flow constraint.
• Fiscal constraint
• Political constraints
• Informational constraints
• Administrative constraints
• Restructuring tasks depend on
  1) degree of product competition
  2) skills of incumbents
  3) needs for external finance
  4) degree of firm independence from government
1) Degree of product market competition.

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

**Efficiency** requirement: demonopolization.

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

Mistake in Russia!
2) Heterogeneity in managerial skills.

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

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

Efficiency requirement: replace management.
Political economy constraint: overcome resistance to layoffs.

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

Efficiency requirement: give incentives for defensive restructuring.
3) Need for external finance.

- Firms with no retained earnings
  Raising outside funds requires giving up control rights.

- Firms with retained earnings.
  Moral hazard problem of empire-building.

**Efficiency requirement**: give control to outsiders.

Political economy constraint: overcome resistance from empire-builders.
4) Degree of firm independence toward government.

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

**Efficiency requirement:** mechanisms for government commitment.

NB: Weakening government reduces intervention but may increase soft budget constraints.
- bad,
- very low outside option

- bad,
- low outside option

- good,
- high cost of defensive restructuring

- good,
- low cost of defensive restructuring
- insufficient retained earnings

- good,
- low cost defensive restructuring
- sufficient retaining earnings

- bad,
- high cost of defensive restructuring
- insufficient retained earnings

- good,
- low cost of defensive restructuring
- sufficient retained earnings

- managerial skills and firm profitability

resistance to privatization and restructuring

Replace Management

provide outside finance

provide outsider control to avoid empire-building

soft budget constraint

ratchet effect

incentive for defensive restructuring
4. Consequences of privatization policies on corporate governance and restructuring.

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

1. Resistance to privatization and restructuring
   - bad,
   - very low outside option

2. Resistance to privatization and restructuring
   - bad,
   - low outside option

3. Resistance to outsider control
   - good,
   - high cost of defensive restructuring

4. Resistance to outsider control
   - good,
   - low cost of defensive restructuring
   - insufficient retained earnings

5. Resistance to outsider control
   - good,
   - low cost of defensive restructuring
   - sufficient retained earnings

- Managerial skills and firm profitability

- Provide outside finance
- Provide outsider control to avoid empire-building
- Soft budget constraint
- Ratchet effect
- Incentive for defensive restructuring
- Replace Management
- Fast giveaway to dispersed outside owners
Fast giveaway to insiders

- resistance to privatization and restructuring
  - bad,
  - very low outside option

- replace management

1

2

- bad,
- low outside option

- low cost of defensive restructuring

3

- good,
- high cost of defensive restructuring

4

- good,
- low cost of defensive restructuring
- insufficient retained earnings

5

- good,
- low cost defensive restructuring
- sufficient retaining earnings

- managerial skills and firm profitability

provide outside finance

provide outsider control to avoid empire-building

soft budget constraint

ratchet effect

incentive for defensive restructuring
Top-down sales to outsiders

1. Bad, very low outside option
2. Bad, low outside option
3. Good, high cost of defensive restructuring
4. Good, low cost of defensive restructuring, insufficient retained earnings
5. Good, low cost defensive restructuring, sufficient retained earnings

Replace Management

Provide outside finance
Provide outsider control to avoid empire-building

Soft budget constraint
Ratchet effect
Incentive for defensive restructuring

Resistance to privatization and restructuring
Resistance to outsider control
- Managerial skills and firm profitability

Resistance to outsider control

Top-down sales to outsiders

Provide outside finance
Provide outsider control to avoid empire-building

Soft budget constraint
Ratchet effect
Incentive for defensive restructuring

Resistance to privatization and restructuring
Resistance to outsider control
- Managerial skills and firm profitability

Top-down sales to outsiders

Provide outside finance
Provide outsider control to avoid empire-building

Soft budget constraint
Ratchet effect
Incentive for defensive restructuring

Resistance to privatization and restructuring
Resistance to outsider control
- Managerial skills and firm profitability
Gradual sales

1. resistance to privatization and restructuring
   - bad,
   - very low outside option

2. - bad,
   - low outside option

3. - good,
   - high cost of defensive restructuring

4. - good,
   - low cost of defensive restructuring
   - insufficient retained earnings

5. - good,
   - low cost defensive restructuring
   - sufficient retaining earnings

- managerial skills and firm profitability
- resistance to outsider control

Replace Management

provide outside finance

provide outsider control to avoid empire-building

soft budget constraint

ratchet effect

incentive for defensive restructuring
Summary Effects of privatization policies.

<table>
<thead>
<tr>
<th></th>
<th>mass privatization to dispersed outsiders (Czech republic)</th>
<th>mass privatization to insiders (Russia)</th>
<th>Top-down sales to outsiders (East Germany)</th>
<th>Gradual bottom-up sales to outsiders (Poland, Hungary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objectives:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- replace management</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>- defensive restructuring</td>
<td>partial</td>
<td>partial</td>
<td>Yes</td>
<td>gradual</td>
</tr>
<tr>
<td>- outside funds and control</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>gradual</td>
</tr>
<tr>
<td>- hardening budget constraints</td>
<td>Partial</td>
<td>Partial</td>
<td>Yes</td>
<td>gradual</td>
</tr>
<tr>
<td>- prevent asset-stripping</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>partial</td>
</tr>
<tr>
<td>Political Constraints:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- resistance to redundancies</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>- resistance to empire-building</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
5. Dynamic effects of differences in initial allocation of economic power generated by privatization

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

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

• => high wealth inequality => political instability => short-termism and asset-stripping
mass privatization => lock-in in corporate governance system with low stockmarket liquidity, large business groups, weak law enforcement and political instability.

In Czech republic, entry in EU helps, but in Russia?
Gradual sales create less sudden concentration of economic power but give time for private capital accumulation based on new private sector (SME’s).

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

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

- Heterogeneity in restructuring tasks facing firms.
- Importance of initial choice of privatization policy. Effects not only on restructuring outcomes but also on economy-wide performance and evolution of institutions.
- Mass privatization creates strong initial concentration of economic power in hands of insiders => evolution toward large business empires, small stockmarkets, weak and captured governments, political instability.
- Gradual sales have lower initial concentration of power, rely on entry, learning and private capital accumulation, SME’s as constituencies for further reform. Create economic safeguards against asset-stripping. Natural evolution of capitalism instead of jump-starting capitalism.