Macroeconomic Stabilization and Privatization in Central and Eastern Europe

Renzo Daviddi
Senior Lecturer, EIPA

It is by now rather clear that the economic transformation of post-communist economies is not an easy task. Despite the common aim of building a market economy and the large number of similarities in the programmes adopted, approaches to stabilization, privatization and restructuring followed by transitional economies have varied markedly from country to country.

In a nutshell, the preliminary condition for access to support from international organizations, in the framework of the G24, has been the conclusion of an agreement with the International Monetary Fund. This has meant introducing conditionality criteria (largely derived from stabilization experiences i LDCs), based on restrictive monetary policy, fiscal consolidation (i.e. drastic reduction of the fiscal deficit) and elimination of subsidies. Additional elements concerned the choice of one or more nominal anchors (needed for price stability), the exchange-rate regime and the use of income policy.

Results achieved so far differ widely among countries. Some (Poland and the Czech Republic above all) seem to have reached the end of their stabilization-induced recession, others (i.e. some of the former Soviet republics) have just started to struggle with the strictures imposed by the regime change.

Despite the fact that a large part of the existing economic literature used to refer to different planned economies in Central and Eastern Europe as being characterized by identical economic systems, at the beginning of transition these countries displayed different institutional settings, varying degrees of centralization of decision-making and different economic conditions. In particular, the extent of macroeconomic disequilibrium and price distortions varied widely across countries. Czechoslovakia, for instance, started its transition with a relatively satisfactory macroeconomic situation, but Poland, Hungary and Bulgaria had to deal with very large foreign debts. Productive capacity resulting from the process of socialist economic integration in the framework of the CMEA turned out to be much more noticeably out of line with economic rationality for some countries (e.g. Bulgaria) than for others.

Privatization is certainly one of the main building blocks of transition in Eastern Europe. A crucial role in the process of macroeconomic adjustment and restructuring has been assigned to it. The transfer of ownership rights from the state to individual citizens in post-communist societies has received strong political priority and the unconditional support of the new policymakers. The introduction of privatization has signified an enormous break with the past, as often perceived by the population, and an essential component in the regime change.

However, the advantages of rapid and thorough ownership transfer have been overestimated. Privatization has been seen as having only positive effects, a sort of panacea capable of immediately solving all the transition problems. The transfer of property rights, mostly by transferring economic activities to the private sector, should have taken place within a few months of the beginning of the adjustment process. According to the prevailing view, all viable enterprises should have been privatized as quickly as possible, and all non-viable enterprises closed. Very rapid privatization was deemed necessary for a number of reasons:

a. in order to prevent expropriation of the existing assets by the nomenklatura and managers;

b. in order to break the political control over the enterprises;
With the benefit of hindsight, all this emphasis on speed cannot be entirely justified. Even assuming that, in the distorted world of centrally planned economies on the eve of transition, it would have been possible to draw a distinction between non-viable enterprises and enterprises in temporary difficulty, many of the benefits that are generally associated with privatization in transitional economies (increase in efficiency, consolidation of democracy, raising revenue for the state budget, etc.) do not seem to derive any particular advantage from the rapid implementation of privatization plans. Quite the contrary: the lack of some key institutions has constrained the process dramatically. In reality, privatization (particularly of large state-owned enterprises) has proceeded much more slowly than envisaged and, in some countries, private activity has grown more as a result of the birth of new firms rather than of the privatization of existing state assets.

The experience of developed market economies (and, to a lesser extent, of some developing countries) has often been recalled as a useful model for economies in transition. There are indeed elements which can be extracted and lessons to be learned; however, there are also enormous differences which should be kept in mind. First, there is a difference in aims. Western privatization was mostly devoted to reducing the presence of the public sector, as producer, in the economy. The main objective of privatization for post-communist economies is the creation of a market environment, moving away from the previous hyper-centralized command system. It follows that the scale of the exercise is completely different. While, in principle, privatization in Western countries does not require an ad hoc legal framework, economies in transition have faced the necessity to adopt an extensive body of legislation and create a number of specialized institutions. Western market economies are characterized by the existence of markets for corporate control, financial markets, stock exchange, etc. These institutions, built over centuries of capitalism, take a variety of forms in different countries and perform a large number of functions, especially with respect to transfer of ownership and control of the performance of managers and firms. These institutions are not present in transitional economies and it is by now very clear that it would take time to set them up.

The above considerations should not be interpreted as implying that before starting to privatize, a proper institutional setting must have been established. The issue is that strategies should have been tailored more to reflect the institutional settings of the countries involved. In particular, the debate seems to have centred mostly on the speed of the privatization process, leaving aside at least one other important aspect, i.e. to what extent should the state divestiture have been pushed. A quick and complete transfer of ownership of all existing assets to private hands is only one possible way of expanding the share of the private sector in the economy but this has turned out to be costly and time-consuming in many cases. Other options, e.g. incentive for the growth of private activity or a more gradual and partial transfer of state assets, could and should have been attempted.

But what are the main reasons for which Central and Eastern European policy-makers are in favour of rapid and large-scale privatization? The positive impact of the transfer of ownership rights on the performance of economic agents is often recalled as the main justification. Privatization is meant to induce advantages in terms of static (productive and allocative) and dynamic efficiency. It could be argued, however, that the transfer of property rights from the state to the private sector creates better incentives for efficiency and discipline of workers and managers if and only if this transfer is effected in parallel with an increase in competition and degree of regulation of the economic system. In the case of transitional economies, this aspect has been overlooked, especially by those prominent economists in a position to influence policy-makers. For instance, Jeffrey Sachs, influential economic counsellor of many Eastern European governments, recommends maximum priority being given to privatization, regardless of the state of infrastructures, market conditions and lack of institutions capable of...

Major market failures characterized post-communist economies at the beginning of transition. The structure inherited by the past regime presented features of great concentration, with very few enterprises of very large dimensions in the main productive sectors. Under these circumstances, i.e. if the privatized firm is a monopoly, privatization will not induce all the positive results recalled above. Privatization will indeed change the nature of the principal-agent relationship and the objectives (from party-political planning to profit maximization). However, it may lead to inefficient high prices which have to be traded off against the productivity increases resulting from privatization. Further problems stem from the difficulty in correctly evaluating the assets in an environment characterized by the lack of proper accountancy criteria and a distorted sytem of relative prices. Finally, even if foreign participation is encouraged, prices may be lower than the market value, because of the high risk required by the investment.

Another benefit often mentioned is the positive impact of privatization on fiscal stance, which is generally considered positive. If there are no other variations in the year in which the privatization takes place, revenue from the sale of assets sold at their market value will contribute to reducing the state budget deficit by the corresponding amount. The impact on the following years is not easy to detect. Among the numerous factors which should be taken into consideration, at least three are of direct relevance for an economy in transition: the price at which the transaction takes place, the capacity of the state to increase revenue from taxation of enterprises' profit in the following years, and the use made of privatization proceeds.

Moreover, transitional economies do not seem particularly concerned with the need to use privatization proceeds for improving their fiscal stance. It is by now clear that the transition has entailed enormous social and economic costs. Revenue from privatization could be used to reduce growing state budget deficit, the public debt, or at least its foreign component. But so far privatization has represented a net loss for all post-communist countries. Especially mass privatization schemes envisaging a free (or at nominal fees) distribution of ownership claims have had a zero or marginal (or possibly negative) impact on the state budget, both for the administrative costs of the deal and, even more so, if some degree of enterprise restructuring had been involved.

In conclusion, assessing privatization in Central and Eastern Europe is rather controversial. As regards the rationale for privatization, the conclusion could be put forward that, regardless of the prevailing institutional arrangements, the increase in economic efficiency generally attributed to privatization very much depends on the competitiveness and degree of regulation which characterizes a given economic system. In the case of formerly planned economies, privatization must be carried out in parallel with the introduction of measures regulating market power, and institutions must be created for effective control of the privatization process. It could be argued that despite the indisputable need to expand the activity of the private sector substantially, approaches to privatization more tailored to the institutional reality of the countries in transition could have been used. They would have involved lower costs for the state budget and, arguably, for the economy as a whole.

Notes

1 The share of the state sector in value added in the mid-1980s varied in socialist countries from 65.2% in China to over 96% in the USSR, Czechoslovakia and the GDR. As indicaterogramme in a market environment, post-Allende Chile, concerned firms producing about 25% of GNP. The share of the public sector in value added in Western European countries on the eve of the privatization programmes ranged from 16.5% (in France) to 10.7% (in the UK and FRG).
2 One could consider, for instance, the functions performed by the stock market: risk-sharing, guiding investment, measurement of the value of assets and increase in the value of assets (Tirole, 1992, pp. 227-228).

3 An extensive treatment of the fiscal impact of privatization in market economies can be found in Mansoor, 1988.

Bibliography


