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April 1994 104

CFS Discussion Paper Series

Eastern European Experience with Small-Scale Privatization

A collaborative study with The Central European University Privatization Project

Cofinancing and Financial Advisory Services (CFS)
The World Bank
April 1994

CFS Discussion Paper Series, No. 104

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ACKNOWLEDGMENTS

This paper is the result of a collaborative effort between the Central European University Privatization Project and the Private Sector Development and Privatization Group of the Cofinancing and Financial Advisory Services of the World Bank. An Advisory Committee was established to guide the work and was comprised of staff of the Private Sector Development Department, the Legal Department, and Europe and Central Asia Country Department II of the World Bank.

We would like to thank the Government of Japan for providing substantial funding for this study, and would also like to thank Anil Sood and Ilham Zurayk of the Europe and Central Asia Region for their support in undertaking this study and for their comments on earlier drafts. The Governments of the Czech Republic, Poland, and Hungary also generously provided time, information, and support to the research teams. Steven Friedman and Karin Rebecca Schumann graciously provided organizational support for the whole project. The paper has benefited greatly from the editorial assistance provided by Emily Evershed and Antoinette Burnham.

We wish to extend our thanks as well to the local teams that greatly contributed to the research effort and that were comprised of the following members of the Central European University Privatization Project: Richard Bures, Karel Cermak, Anton Marcincin, Michal Mejstrik, and Emanuel Sip in the Czech Republic; Ewa Appenheimer, Jaroslaw Gora, Wojciech Maciejewski, Piotr Makowski, Agnieszka Pecura, Krzysztof Rybinski, and Wanda Wojciechowska in Poland; and Ferenc Laczo, Erzsebet Lukacs, Monika Lukacs, Maria Mora, Gabriella Pal, Laszlo Szakadat, Istvan Janos Toth, and Laszlo Urban in Hungary.

We are also grateful to PENTOR (and especially to Eugeniusz Smilowski) and ECOMA for assistance in the preparation and carrying out of the country surveys in Poland and the Czech Republic, respectively. George Ftaya provided invaluable technical support in analyzing the results of the survey.

FOREWORD

This study examines the experiences of three Eastern European countries—the Czech Republic, Poland, and Hungary—in privatizing the retail, catering, and service sectors of their economies. The primary objective of the study is to analyze small-scale privatization in these countries in order to identify practical lessons and operational recommendations for decision-makers responsible for implementing small-scale privatization programs in Central and Eastern Europe and Central Asia.

The study focused on the privatization of small non-manufacturing business units, defined for this purpose as business units with fewer than 50 employees in non-manufacturing service sectors, such as retail trade. The study is based on parallel investigations, which include a comparative review of various privatization processes and a survey of privatized business units in each country, and was undertaken between late November 1992 and August 1993 as a collaborative effort between the Central European University Privatization Project and the World Bank. The study is part of a larger effort by the World Bank and USAID to disseminate the lessons of the privatization experience in Eastern Europe. Other studies being undertaken cover: trade sales (World Bank), and mass privatization and corporate governance (USAID).

As a central department of the World Bank, an important function of Cofinancing and Financial Advisory Services (CFS) is to act as a clearinghouse for worldwide experiences in the areas of privatization and private sector development. We are pleased to present this review of small-scale privatization in the Czech Republic, Poland, and Hungary.

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Objectives and Scope

1.1. This study examines the experiences of three Eastern European countries — the Czech Republic, Poland, and Hungary — in privatizing the retail, catering, and service sectors (hereafter referred to as the sector) of their economies. It is still too early for definitive conclusions to be drawn, since the impact on the creation of a vibrant consumer sector may not yet be complete. Thus the conclusions of this study are of necessity qualified and partial. Nevertheless, since these three countries have been grappling with the privatization of this sector since 1989, they have a rich body of experience upon which others may draw.

1.2. The objective of this study is to derive lessons that may be useful to other countries, particularly those of the former Soviet Union (FSU), that are also currently involved in privatizing their retail and service sectors. It is not the objective of this study to assess or rank the overall approaches of each country nor to propose one country's approach as a model. The approach adopted in any particular country would require tailoring to specific country circumstances: the level of political commitment, the success of macroeconomic reforms, the legal and institutional framework, the relative power of various stakeholders, and the organizational structure and performance of the sector. Rather, the objective is to draw general lessons from both the positive and negative experiences of the three countries that could be applied to a variety of programs and country conditions.

1.3. The primary focus is on what is commonly referred to as "small-scale privatization" — the term applied to the programs that transfer ownership of large numbers of shops, restaurants, service outlets, and other small units. Small-scale, or small, privatization has been the main avenue for privatizing the retail and trade sectors. However, since retail sector privatization can also involve larger chains as well as cooperatives, other approaches, including large-scale privatization, will also be examined where relevant.

Organization of the Report

1.4. The present study is based on two parallel investigations: (1) a detailed examination of the process followed by each of the three countries in privatizing the sector, and (2) a uniform sample survey of privatized enterprises in the three countries. This chapter is intended to distill and integrate the broad lessons and conclusions derived from this dual approach — the three country studies and the survey of enterprises. To this end, the chapter briefly summarizes the main cross-country findings and lessons applicable to key aspects of the transformation process. To orient the reader further, a brief description of the approach taken in each of the three countries is provided. Chapters II, III, and IV summarize each of the country studies, and Chapter V discusses the survey.

The Setting

1.5. Prior to the transformation, the retail, catering, and service sectors of the Czech Republic, Poland, and Hungary were dominated by large state enterprises and consumer cooperatives. Both

of these institutional forms were tightly controlled by apex bodies: the former usually by a ministry of trade and the latter by a central cooperatives association that functioned under the government's direction. Individual enterprises, usually comprising a large number of retail units, operated in specifically defined markets and faced little or no competition. Storage and input distribution networks were rigidly controlled by wholesalers operating in specific regions, and retailers had little freedom or flexibility in supply and purchasing decisions. In most cases, the real-estate premises from which the shops, catering, or service establishments operated were owned or controlled by local governments or housing cooperatives. The owners were required to rent the premises to state enterprises for indefinite periods at modest rentals. In developing a privatization strategy for these enterprises, decision-makers faced a number of complex issues with regard to the future structure and efficiency of the retail sector, as well as issues relating to ownership and the preservation of employment.

1.6. While the retail sectors in all three countries were inefficient and provided a limited supply of goods and services to the public, the supply situation in Hungary was relatively better than that in Poland and the Czech Republic because Hungary had initiated reforms in the enterprise sector much earlier. The Hungarian retail sector had benefited from laws dating back to the late 1960s and continuing through the 1980s that allowed the entry of small private businesses in various legal forms into the production and retailing sectors. Nevertheless, the paucity of retail distribution outlets resulted in poor customer service in all three countries: the density of retail outlets in the three countries was about a third of that in Western economies.

1.7. Following the collapse of their command economies, the new governments chose the trade and services sector as one of the first targets for privatization. In many ways, this sector was the easiest to privatize. It was generally felt that private ownership of trade and services would be more efficient, that the absence of economies of scale and indivisible capital implied that relatively few corporate governance problems would arise, and that the under-representation of trade and services in the economy as a whole implied tremendous possibilities for growth.

Diversity of Approaches

1.8. The objectives adopted in all three countries comprised, in varying degrees, privatizing existing state-owned units, reforming the pseudo-cooperative system, and encouraging the entry of new private entrepreneurs. However, there was great diversity in the specific policies and programs used to achieve these objectives. To an important extent, this reflected differences in the political and economic milieus among the countries. The varying outcomes resulting from this diversity of approaches provide interesting comparisons. These different approaches adopted for privatizing the retail and trade sectors cover a wide spectrum, ranging from a classic privatization process of auctioning individual stores (the Czech Republic) to the simple commercialization of real estate (Poland), with a more gradual insider-dominated approach that was often geared toward the privatization of whole enterprises (Hungary).

1.9. In the *Czech Republic*, a transparent auction-based system was adopted as the primary track to privatizing the retail and trade sector. This approach was in explicit opposition to insiders, who were interested in maintaining control over large supply networks and chains of stores and who attempted to manipulate the process to their advantage. The public had little sympathy for the insiders' plight, and newspapers campaigned against insider preferences. As a result, Parliament enacted a small privatization program in January 1991 that adopted open auctions as the method of sale, allowed anyone to propose any asset for sale, and granted no preferences to insiders. The Privatization Ministry supported the privatization of as much property as rapidly as possible. The policy of favoring speed over technocratic issues tended to foster rapid approval of small privatization proposals.

1.10. A second track to privatizing this sector was "reprivatization." Among post-communist countries, the Czech Republic developed one of the broadest programs of restitution, which returned specific assets to their former owners — thus the term "reprivatization." The restitution laws made plain the possibility that any enterprise assets, particularly retail units, would be vulnerable to reprivatization. Thus, for insiders, it was unclear which assets would remain to provide the basis for corporatization.

1.11. Enterprise remnants that survived restitution and small privatization were corporatized, and included in the large privatization program. Enterprise managers anticipated that they could maintain control of their companies if the predominant method of transfer was to be voucher privatization. But the opportunity given to outsiders in late 1991

to submit "competing projects" against the "basic projects" submitted by the insiders, and the outsiders' prompt response, drastically altered the situation. Furthermore, the astonishing success of Investment Privatization Funds in early 1992, which in total attracted 72 percent of all voucher points, promised to create a less dispersed share ownership structure and therefore increased the possibilities for effective control of privatized enterprises, through the use of vouchers.

1.12. In *Poland* there was no separate small privatization program and the impact of the general privatization law was minimal. Instead, a series of governmental acts not directly related to privatization released a spontaneous and largely unregulated process in which the existing special interests were pitted against each other and were enlisted in the process of transformation. The key to this approach was the centering of the transformation not on the privatization of businesses run by the socialized domestic sector but rather on the *transfer of the real estate* on which these businesses operated to the private sector. The essence of small privatization in Poland was thus a transfer of interests in commercial premises to private parties.

1.13. The Housing Act Amendments of 1990 gave impetus to this approach by giving the owners of premises unlimited freedom to terminate a lease of indefinite duration and to rent at market rates. Strapped for resources, the municipal governments (*gminas*) quickly reclaimed large numbers of premises and leased or sold them to private parties. The process was highly decentralized, and insider-negotiated arrangements predominated. In addition to this approach of commercializing real estate, Poland also spurred small privatization by breaking up large cooperative associations through legislation that led to the transfer of a large number of stores and service units to private hands. The remaining state-owned enterprises, generally those on property owned by the central government, are being privatized primarily through the "liquidation" method in which the assets are sold or leased to a new company that has been formed especially for this purpose.

1.14. In *Hungary* the initial conditions for privatizing the consumer sector differed considerably from those in the Czech Republic or Poland. As a result, the process itself was very different. In Hungary, enterprise reform began much earlier. Throughout the 1980s there had been a significant amount of enterprise reform in the consumer sector. State enterprises had been given considerable freedom to operate and restructure themselves. Restrictions on private business activity in the trade sector had been eased, although by no means eliminated, and the state permitted and even encouraged a variety of private economic entities. Legislation on private economic activity also became more liberal. By the late 1980s, all segments of Hungarian retail trade and services included a sizable private component. The new arrangements significantly changed the retail and service sector: they introduced some market-driven elements into the sector and affected the role of the state enterprises in the provision of consumer goods and services.

1.15. Thus by the end of the 1980s, when the major transformation in Eastern Europe was taking place, the reforms had already had a significant impact on the consumer sector. Hungary differed from the Czech Republic and Poland in that there were significant numbers of private establishments in existence at that time. Although the state sector still dominated commercial activity, state enterprises operated with an unparalleled degree of freedom, and a large portion of trade activity was controlled by semi-private individual units. As a result, the trade sectors operated with a tolerable degree of efficiency. Finally, and significantly, the managers had increased their strength and bargaining power vis-à-vis the government and had become important stakeholders whose views and interests needed to be taken into account if further reforms were to succeed.

1.16. The complex status of the state sector and the increased power of the managers made it difficult for the government to proceed according to any centralized or comprehensive design to privatize the trade and service sector. Nor was the government able, as in Poland, to provide incentives to selected outsiders, such as municipalities and other real-estate owners. Consequently, Hungary's approach to privatizing shops and restaurants has been made up of a *mosaic* of small programs targeted at discrete segments of the trade sector. Transfer of individual shops to private parties was deemed appropriate for only a portion of the sector. The majority of state assets involved in trade and services have been, or are about to be, privatized in ways that emphasize the transfer of many units grouped together to form integrated commercial entities.

1.17. In the late 1980s, state enterprises and unit managers in Hungary were encouraged to form separate business entities from a portion of the assets of existing parent companies. This led to a

significant increase in the number of retail and catering units operated by incorporated companies. In 1990, the Preprivatization Program was adopted, which was the only program designed specifically for the transformation of the retail, catering, and service sectors. An important objective of this program was to address the abuses of uncontrolled spontaneous privatization. The Preprivatization Program targeted the smallest units in the sector for sale, predominantly by auction. Enterprise managers had incentives to keep their most valuable units together as a network and to release only their least valuable units to Preprivatization. About 12,000 state-owned units have been identified for sale under this program, but actual sales have been significantly fewer. By mid-1993, some 7,000 units had been sold or otherwise transferred out of the state sector.

1.18. The government has also attempted to privatize entire enterprises, initially in the experimental First Privatization Program, and later in the larger Self-Privatization Program. While the First Privatization Program has generated few sales, the Self-Privatization Program has had more success in privatizing primarily small service enterprises, selling more than 70 firms. In addition, the government is attempting to sell chains of stores outside the framework of formal programs. Finally, there has been a continuing process of cooperative reform. Beginning as early as the 1960s, it led to the sale of a large portion of cooperative stores in the years between 1988 and 1990. Since 1990, cooperatives have retained approximately the same number of units but have gradually shifted their mix of stores toward more multi-use establishments.

Results

1.19. Overall, the results have been impressive. In the Czech Republic, nearly all state-owned trade and service establishments had been privatized by the end of 1992. In Poland, by the end of 1992 the great majority of all shops and other consumer outlets were officially estimated to be in private hands. This comprised large numbers of new entrants as well as privatized units. At the end of 1992, small privatization in Poland was almost complete with the privatization of about 194,000 units, representing 82 percent of the units that were owned in 1989.

1.20. The situation in Hungary is much harder to quantify, in part because of mixed ownership and also because property relations in the sector are often unclear and information about ownership can be difficult to obtain. Over 10,000 shops and catering units have been privatized, primarily through the Preprivatization Program. Over 12,000 individual units have remained under state ownership, a much greater proportion than in Poland or the Czech Republic, partly as a result of the conscious policy of privatizing entire enterprises. The Hungarian retail sector has also been transformed by the rapid entry of a large number of private operators. In addition, many enterprises under state domain operate with significant amounts of independent initiative and incentives.

1.21. It should be stressed, however, that the data on privatization for all three countries relate only to the initial transfer of premises to private owners, and the extent of secondary market transactions is still unknown. Important restrictions remain on the use of these assets, such as limited security of tenure, restrictions on change of line of business, resale, etc., which may retard the further development of a vibrant retail, catering, and trade sector.

Transfer of Assets

1.22. Generally, privatization implies the sale of a state-owned enterprise, usually as a going concern, to private owners. The experience with small privatization in Eastern Europe has brought up an important distinction in this respect. Insofar as the retail units themselves were concerned, it quickly became apparent that there was little value in many of them beyond the premises that could be used productively. The furnishings and equipment were generally inadequate and in poor condition, and inventories were often worthless or nonexistent. Supplier contacts were of no long-term value with the change to private suppliers, and staff were usually in excess of needs and lacked adequate marketing and sales skills. Thus, although the actual approach to small privatization differed significantly among the three countries, the essence of small privatization was the transferring of the premises to private owners.

1.23. Poland was unique in that the transformation of retail trade, catering, and consumer services was explicitly centered on the real estate on which the businesses had been operated. Nonetheless, the survey data indicate that in all three countries the transfer of premises was the core of small privatization, with the other business assets playing a sec-

ondary role (see Table 1.1). In fact, the less developed the consumer trade sector is prior to the reform, the more likely it is that the transfer of real estate will dominate the entire privatization transaction. This may be of particular importance in the FSU countries, where densities of stores and inventory levels are very low. The focus on real estate also favors the breakup of inefficient large retail enterprises in the former command economy countries and promotes the privatization of individual units.

1.24. An important lesson to be gained is that much time and effort might be saved by focusing on transferring the key asset—real estate or business premises—rather than on privatizing going concerns or business activities. In addition, since commercial real estate is a scarce economic asset, it is important that it be allocated to its most economic users. Encumbering the transfer of real estate with other assets and liabilities is clearly not the most efficient way to achieve this transfer. The Polish approach, that of directly freeing up real estate, was a very effective means of achieving this, and its feasibility in other country contexts merits consideration, even if it is parallel with a conventional enterprise approach. Post-liquidation sale of assets, especially the real-estate asset, is another alternative which allows the focus to fall squarely on this key asset. Where for political reasons the sale of going concerns is unavoidable, the preprivatization valuation and sale should focus on this asset. There is little to be gained by more in-depth valuation of the business as a going concern.

1.25. An important corollary to focusing on the real-estate asset is that efforts should be made to develop a secondary real-estate market for commercial space in order to ensure efficiency in the allocation of this scarce resource. This is especially important where the initial allocation methodology is biased toward current workers and managers and where non-market transfer mechanisms predominate. No special measures to develop such secondary markets were identified in the three countries. Clearly, it will be increasingly important to develop such measures to ensure that the limited space can be put to good use.

Ownership Rights

1.26. While the various programs grappled with methods of transferring enterprises and especially premises, the actual rights conveyed were highly restricted. Ownership rights to most of the premises on which the privatized establishments operated were not conveyed; rather, only rights to leases were allowed.

1.27. The survey data confirm that the premises themselves are most often not privatized in the strict sense of the word. Since, in the three countries, 75 percent of the privatized units lease the premises, the legal title to these premises is not conveyed into private hands. Only 12 percent of the premises in the sector are owned by private individuals or institutions (other than cooperatives).

Table 1.1: Parts of the Business Included in the Transfer[1]

Part of the Business	% of Units for which a Given Part of the Business Was Transferred		
	Czech Republic	Poland	Hungary
Premises	100	100	100
Equipment	35	40	37
Land	20	15	11
Building	28	31	35

[1] Transfer means rental or purchase.

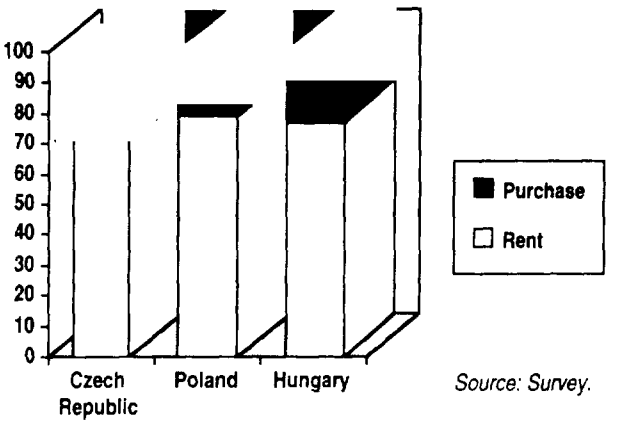
Source: "Survey of the Joint Study of the Central European University (CEU) and the World Bank" (hereinafter referred to as Survey).

1.28. In the Czech Republic, of the approximately 23,000 trade and service establishments included in the small privatization program, only about 28 percent were or are to be sold with premises (Figure 1.1). For the remaining 72 percent, the auction winner purchases equipment and inventories and receives only the right to rent the premises for a fixed term. In Hungary's Preprivatization Program, which was specifically designed for the transformation of the retail trade, catering, and service sector of the economy, typically, the parent company did not have formal title to the premises on which its shops operated. De facto property rights belonged to local governments, to which enterprises had been paying rent at favorable terms. Thus, over 70 percent of the sales did not include premises; rather, they involved the purchase of the right to rent the premises for a period of ten years. Units were sold as going concerns, and thus included the equipment, brand names, existing contracts, and obligations of the business. Sales, however, did not include inventories.

1.29. Moreover, the lease terms were frequently short. Hungary was the only country surveyed with a high percentage of leases with terms of five years or more (88 percent). In Poland, a high proportion of leases have terms of two years or less (see Figure 1.2). The lack of a functioning real-estate market combined with short leases raises the obvious uncertainties of being able to stay in business after the lease terminates. The survey therefore examined the relationship of lease tenure to post-privatization behavior (as measured by investment in remodeling). The findings on this were clear.

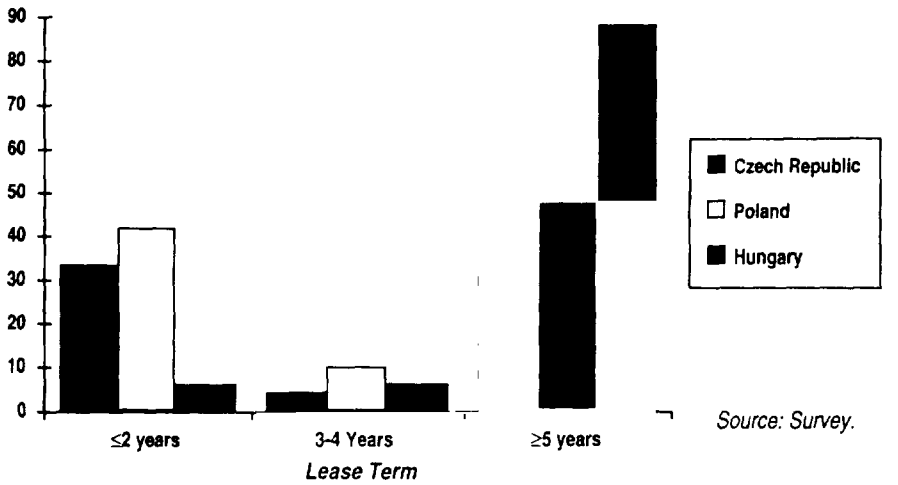
1.30. Lease duration is one of the key driving forces of post-privatization investment. Units with lease terms longer than five years had more than double the investment rate of those with leases shorter than five years. This is further confirmed when contract risk is examined. An option to

Figure 1.1 Transfer of Premises: Lease versus Purchase
(Percentage)



Source: Survey.

Figure 1.2: Duration of Rental Contracts for Premises
(Percentage)



Source: Survey.

purchase raises the mean level of investment in comparison with rental with no option (see Figure 1.3).

1.31. A substantial proportion of the transfer contracts that were examined have restrictions on changes in line of business or on subletting and resale. Restrictions on subletting and resale, for example, severely impede the operation of second ary markets and therefore hamper improvements in the original allocation. According to the survey, the time frame of these restrictions is approximately equal to the average length of the rental contracts. Similarly, imposing restrictions on changing the line of business can significantly restrict new owners from responding to market forces in a cost-effective manner.

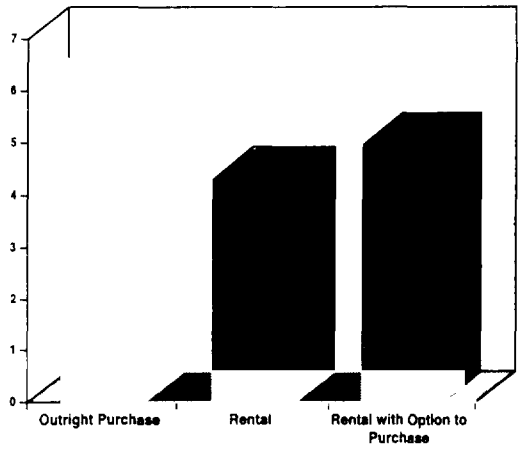
1.32. For the rapid development of an efficient market-oriented retail and service sector, there appear to be significant benefits in conveying the full title of the real estate with as few restrictions as possible. In cases where leases are unavoidable (e.g., in a multiple unit building in the absence of condominium laws), a duration of at least five years should be granted with an option to renew. The renewal process should be transparent and clearly defined at the outset to reduce the degree of uncertainty for potential bidders. Other restrictions on resale, line of business, and employment should be avoided as much as possible.

Importance of Outsiders

1.33. An important finding of the study is the significant role of outsiders in post-privatization investment. The survey measured post-privatization behavior by the level of remodeling investment in the enterprise after privatization. While this is less than a perfect indicator, it is one of the few indicators subject to unambiguous measurement and is reasonable in view of the widespread dilapidated condition of shop premises and the consequent need for new investment. The survey data clearly show that outsiders are likely to invest significantly more than insiders in the business after privatization. As can be inferred from Figure 1.4, this

Figure 1.3: Effects of Contract Risk on Post-privatization Investment[1]

($ Thousands)

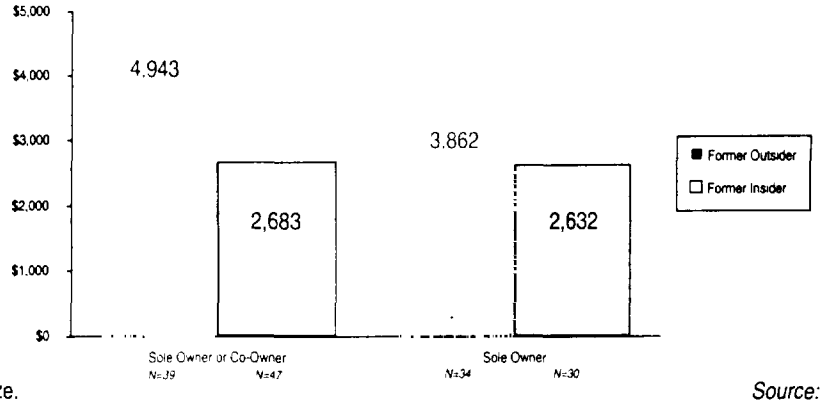


[1] Pooled data of all three countries.

Source: Survey.

Figure 1.4: Post-Privatization Investment: Outsiders versus Insiders

(Pooled data)



N denotes sample size.

Source: Survey.

result is not due solely to the presence of outsider co-owners presumably brought in to improve the financial position of the business, since single outsider owners also invest significantly more than single insider owners.

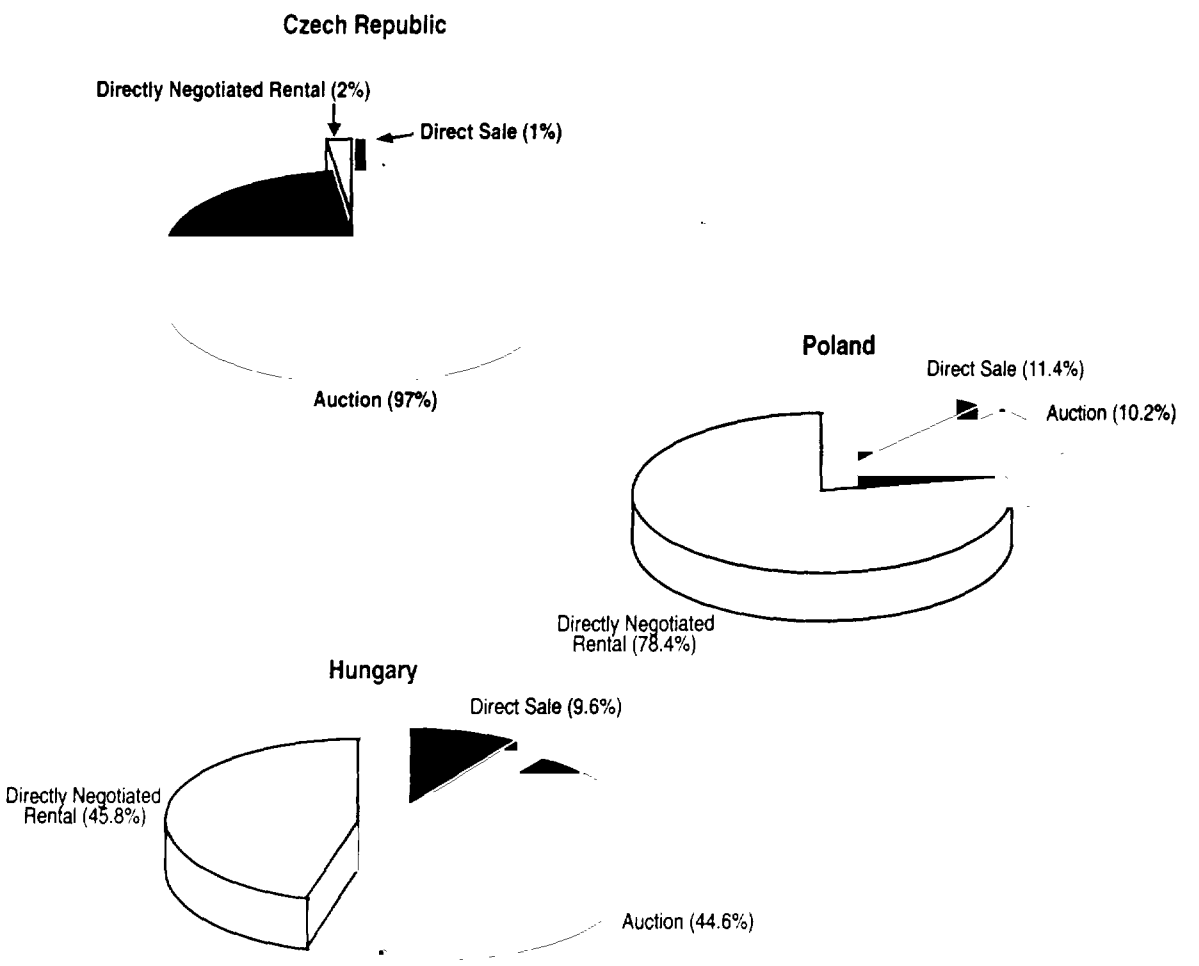
1.34. This finding is not surprising, since outsiders have more resources than insider employees in what is a traditionally low-paying sector. A simple multivariate regression model supports the conclusion that the effect of outsider ownership on investment following privatization is dominant. The implication of this finding for the method of sale is discussed below.

Method of Sale

1.35. The three countries used a broad range of sales methods. The exclusive method of allocation of ownership rights used in small privatization in the Czech Republic has been public auction. In Poland the vast majority of the units have been allocated on the basis of closed procedures and at prices that most often have not reflected their market value. Hungary used both auctions and negotiated sales extensively. The distribution of methods used, based on the survey of privatized enterprises in the three countries, is presented in Figure 1.5.

1.36. The appropriateness of the procedures used in transferring ownership rights is a subject of considerable debate in small privatization. The fundamental question that can be raised is: Do the potential benefits of open procedures (auctions and open tenders) — efficiency, equity, and transparency — outweigh the potential advantages of insider support inherent in closed procedures? This

Figure 1.5: Mode of Transfer of Premises



Source: Survey.

study does not attempt to give a definitive answer to this complex question. However, the study and particularly the survey results underscore the potential efficiency benefits associated with open procedures.

1.37. With regard to method of sale, the survey results indicate that investment (post-privatization) in units transferred through open procedures (auctions and open tenders) was significantly higher (46 percent) than in units transferred through closed procedures (negotiated sales and closed tenders). This result in turn appears to be related to one key factor: open procedures are much more likely to result in outsiders taking over the business.

1.38. Thus, there are clearly benefits in involving outsiders in the original privatization process. This means using open sale methods wherever possible. In addition, priority should be given to other measures that attract outsider participation, such as wide dissemination and advertisement of sales. Open procedures also provide an element of transparency and thus there is less likelihood of public criticisms of abuses, which can slow or even derail privatization programs, as, for example, was encountered in the early reforms in Hungary.

1.39. Open procedures and other efforts to bring in outsiders are likely to encounter resistance from entrenched insiders, and governments will need to give special attention to addressing the interests of existing stakeholders who can slow the process. The appropriate balance can be struck only within specific country contexts depending on the array and strength of various stakeholders. In general, however, in view of the benefits outsiders can bring to the transformation process, giving insiders a preference (discount) in bidding would appear preferable to using procedures that exclude outsiders altogether.

1.40. Finally, the benefits of bringing in outsiders also suggest that increased attention be given to new entrants, who constitute a large potential pool of outsiders; this is further addressed immediately below. The survey results also underscore the need for the rapid development of secondary real-estate markets, which can allow outsiders to bid for business premises that insiders (or others) may be putting to poor use.

New Entry

1.41. Analysis of the growth of new private businesses was outside the scope of the study. However, it is evident from the findings that new entry is critical to the development of an efficient market-oriented trade and service sector. This is particularly important in cases in which there has been an overall domination of ownership of the privatized entities by insiders.

1.42. New businesses have emerged in all three countries, but Poland and Hungary in particular have experienced a rapid growth. In Poland, for example, despite a rapid and comprehensive program that privatized 82 percent of consumer outlets by 1992, the number of new private outlets was more than twice the number of privatized units. The growth in new businesses, however, was largely driven by the emergence of very small units operating from own garages, homes, trucks, and roadside kiosks. In Poland, these types of businesses accounted for two-thirds of the growth of new businesses, and the new private sector's share of turnover is only 25 percent of the total. Although they are less numerous than the rest of the new private businesses, the units formerly owned by the socialized sector still constitute by far the most important segment of the domestic consumer trade sector, dominating from the point of view of their size and location, and their affiliation with wholesale establishments.

1.43. Even so, the growth of new entrants is striking (see Table 1.2), and despite the small size

Table 1.2: Poland: Privatization versus New Firms[1]
(Thousands)

From 1989 through 1992	Privatized Outlets	Net New Private Outlets
Retail Outlets	145	501
(Retail Stores)	(115)[2]	(202)
Catering Outlets	15	22
Service Outlets	34	46
Total	**194**	**476**

[1] Includes new outlets opened and closed on premises not originally part of the socialized domestic trade network.
[2] Includes ca. 46,000 cooperative and other stores that have been reclassified as "private."

and often transitory nature of these outlets (the failure rate is at least 20 to 30 percent per year), the proliferation of small private outlets played a very important role in creating a genuinely competitive environment in some product and market segments.

1.44. This growth in the number of stores has in fact brought the Polish shop density levels in line with those of the Western economies, although the average store size is substantially lower. The density of stores in Poland in 1992 was about 9 per 1,000 inhabitants, while Austria, France, and the United States had an average density of 7, 10, and 6 stores per 1,000 inhabitants, respectively.

1.45. The most critical barrier to new entry is lack of access to real estate — that is, to both the ownership and rental of commercial space. Only if this barrier is addressed can a truly competitive environment in all product and market segments of the retail and service sector emerge. This suggests that, concurrent with formal privatization, equal importance should be given to the releasing of real estate to new businesses. This could be carried out as part of the formal privatization program by, for instance, making arrangements for the subdivision of premises occupied by state enterprises that are being privatized. Alternatively, or in addition, it could be accomplished by focusing on making available other real estate owned by the state which is suitable for commercial use. In view of the results of the study, special pilot efforts are being mounted in Russia, Ukraine, and Kazakhstan to pursue options to increase access to commercial space for new units.

Employment

1.46. As the number of outlets in all three countries grew rapidly in the wake of the reforms, the consumer sector represents one of the few dynamic areas of growth. Total employment in the Polish trade sector grew by 6 percent between 1989 and 1991. The increase in employment in this sector should be considered in light of the overall rise in unemployment, which reached 12 percent of the labor force during the same period.

1.47. The average employment per unit in the sector is growing in both Hungary and the Czech Republic, but in Poland the number of both managerial and non-managerial employees is unchanged. The ratio of managerial to non-managerial compensation increased in all three countries, which indicates a positive evidence of post-privatization restructuring. Given the relatively flat compensation curve characteristic of the old system, the change is likely to result in a significant modification of managerial incentives.

1.48. There is strong evidence in the survey that an overall increase in employment can be achieved by the privatization of retail and services sectors. Such an increase in sector employment significantly reduces the social pressures of dislocation owing to privatization. This suggests that there are tangible benefits to be gained from directing efforts to stimulate the growth of new businesses rather than debating over issues relating to worker retrenchment.

Competitive Units

1.49. There is a clear bias on the part of the enterprise managers and the ministries of trade in many post-command economy countries to protect the structure of the large trade enterprises. In Hungary, the law provided ample opportunity and legal basis for enterprises to argue that their units comprised a chain of stores, and should thus be excluded from the Preprivatization Program. It also permitted the enterprise managers to retain their most valuable units as a network of shops and to release only their least valuable units to privatization.

1.50. The most common line of argument taken by the Czech insiders in favor of inclusion of their enterprises in large privatization was that a certain unit or units made an essential contribution to the operation of the entire enterprise, without which the entire network would lose viability. In addition, the Ministry of Trade officials argued that the sale of individual units through small privatization auctions would destroy economies of scale in chains of shops and vertically integrated networks.

1.51. Although some of these arguments may be valid, on balance there are significant advantages in dissolving the chains and associations and selling off individual units. The "creation" of smaller individual units not only improves the density of independent retail and services entities but also provides a way of empowering a new class of entrepreneurs. Protection of large enterprises, on the other hand, can lead to further concentration of the sector if the larger enterprises start acquiring the smaller ones. This, coupled with the fact that the existing large enterprises most often have a supply chain which is vertically integrated, can lead to the preservation of the status quo and can move the

sector away from the objective of creating an efficient market for consumer goods and services.

Policy Implications

1.52. While the policy conclusions of this study must be qualified by the small sample size and the ongoing nature of the process, the study does nevertheless raise a number of policy implications for other countries to consider in formulating and executing small-scale privatization programs. A "short list" of such policy implications could be the following:

- Small privatization is, above all, related to the transfer of control (and not necessarily ownership) of *real estate* from the state to private parties. Thus, policies should concentrate on making premises available to private businesses, and should place less emphasis on transferring movable assets and business activities.
- Sale of premises should probably be favored over leasing, since the former provides greater security of tenure and encourages investment in the privatized units.
- Leases should be of long duration, preferably over five years, and, if possible, should contain options to purchase or renew.
- Where only the right to lease is transferred, transparent and certain procedures for setting rents and lease terms should be established prior to transfer.
- Post-sale restrictions on employment and line of activity should be avoided or minimized.
- Facilitating the entry of outsiders is probably the most important element in fostering the restructuring of businesses in the wake of privatization. This can be done by a variety of measures:
  - Wherever possible, open sale procedures should be employed; this, by definition, allows outsiders to participate.
  - Priority should be given to announcements in the media of privatizations of shops and restaurants; this significantly enhances the participation of outsiders.
  - Small privatization should be refocused on the increased availability of real estate, combined with an overall increase in the number of retail and service units. This could be further facilitated by encouraging present landlords and tenants to make more commercial space available for new businesses.
  - The formation of secondary markets for privatized businesses should be fostered. In particular, restrictions on secondary transfers of privatized units should be avoided.
- Privatization of the retail sector may have significant effects on the reform of the wholesale sector if appropriate steps are taken by the government. In particular, increasing the availability of the means of transport (above all, trucks) to the private sector may have a very significant effect on restructuring the supply system.
- Price stability and other macroeconomic factors are extremely important for small businesses, and their absence is cited by most respondents as a significant obstacle to the development of these businesses.
- Breaking up large retail chains and selling off individual units is likely to enhance competition and to speed up the transformation process.

Chapter Two

The Czech Republic

A. Introduction

2.1. This section analyzes the experience involving the privatization of the trade and service sector in the Czech Republic. Some 68,000 state-owned and cooperative trade and service establishments existed in the Czech Republic at the end of 1989. These comprised about 44,000 retail establishments, 19,000 catering units, and 5,000 hotels, etc., and service units of municipalities.[1] Table 2.1 provides a breakdown of the different types of establishments in the sector including the distribution of ownership between the state and the cooperatives.

2.2. For state-owned establishments, three different tracks were adopted for the privatization of assets in this sector. Estimates of the number of establishments in each of these tracks are shown in

Table 2.1: Czech Republic: Numbers of Trade and Service Establishments as of December 31, 1989

		State	Coops	Total
Retail Trade		**26,905**	**16,876**	**43,781**
Of which:	Food Stores	10,580	4,290	14,870
	Mixed Stores	400	8,029	8,429
	Non-Food Stores	12,220	2,525	14,745
	Department Stores	53	762	815
	Kiosks	3,216	307	3,523
	Others	436	963	1,399
Restaurants and Pubs		**10,105**	**9,374**	**19,479**
Hotels, Motels, and Camps		..	..	**2,863**
Of which:	Hotels and Motels	..	..	860
	Pensions	..	..	1,353
	Camps	..	..	650
Service Units of Municipalities		**2,088**	..	**2,088**
Total		**39,038[1]**	**26,250**	**68,211[2]**

[1] This figure and the total for cooperatives do not include hotels, motels, pensions, and camps, since the available data allow no breakdown of this category by ownership.

[2] Unlike the separate totals for state and cooperatives, this total includes hotels, motels, pensions, and camps.

Sources: "Ukazatele v maloobchode," ECOMA Praha, mimeo, 1993; *Statistical Yearbook of CSFR 1990*, SNTL-ALFA, Praha 1990, pages 515, 517, and 534.

Table 2.2. The most important was the "small privatization program" (SPP), a program of competitive auctions of individual establishments. The small privatization program also includes some assets that cannot be strictly classified as part of trade and services. The second track was "reprivatization," the restitution of expropriated property to former owners, which has also been quite important quantitatively. The third track was the "large privatization" program, which applies voucher, direct sale, and other methods to privatize generally larger entities. Other state-owned assets in trade, largely wholesale enterprises and the remaining shells of former trade enterprises, are being liquidated. The future of some of the state-owned assets, particularly in wholesale distribution, is not yet decided, but they are probably also destined for either the large privatization program or liquidation.[2]

2.3. Consumer cooperatives, which made up a significant proportion of the sector before 1990, have gradually been divesting control over their assets, while the remaining cooperative establishments are experiencing a partial "transformation" of their governance and decision-making structures. Of the approximately 26,250 cooperatively held establishments in trade and catering in 1989, plus some hotels and motels, about 3,500 have been reprivatized, 4,000 have been leased, and about 12,000 have either been sold or lost to municipalities.[3] Only about 7,000 remaining cooperative establishments are thus subject to the new regulations intended to transform their decision-making structures.

2.4. The division of state assets among the various divestiture methods is the outcome of competing claims put forward by a variety of interest groups beginning in 1990. First, popular antipathy toward the former regime led to a movement to compensate Czechoslovak citizens or their descendants who had been victims of nationalization and expropriation through the restitution of property. Because reprivatization had legal precedence over the other methods, the difficulties in clarifying ownership rights, which had often become muddled over time, affected privatization throughout the sector. Second, the sector "insiders," including Ministry of Trade officials and enterprise managers, favored gradual decentralization and privatization of the existing structures, with little reorganization of trade enterprises. They proposed leasing arrangements for some establishments and the reorganization of the rest into new companies along the lines of the former district divisions. These proposals could be regarded either as attempts by trade officials and enterprise insiders to maintain control of their valuable empires, or as "technocratic" arguments, based on the experience and knowledge of "experts" and "specialists," for efficient privatization of assets. Third, reformers who had just come to power, for example in the Ministry of Privatization, supported rapid privatization of individual trade units with few or no preferences for insiders. This policy was consistent with what became the predominant thrust of the Czech approach to privatization more generally: to break the monopoly of the *nomenklatura* and create

Table 2.2:
Czech Republic: Estimated Division of State-Owned Trade and Service Establishments According to Method of Privatization

Method	Number of Establishments	Share Percentage
Restitution	13,500-16,500	33-40
Small Privatization	23,500	57
Large Privatization	2,000	5
Liquidation	0-3,000	0-7
Total	**41,000**	**100**

Note: Estimates are the authors' own. Liquidation is calculated as a residual.

a new class of small-scale entrepreneurs who would support the reform program and the new government. The debate between the second and third lines of argument, what we may term the "insider/outsider debate," turns on much more than simple self-interest. It also concerns the issues of whether shops should be privatized singly or in chains, whether retail should be separated from wholesale trade, and what should be done with accumulated financial liabilities and other obligations.

2.5. The methods eventually applied to privatize the sector are the outcome of a process in which these competing arguments and interests contended. In addition to enterprise managers, restituents, and Privatization and Trade Ministry officials, various interest groups attempting to influence asset transfers emerged during the process. Among them were a variety of potential new owners: entrepreneurs, foreigners, and shop managers and workers. The keenest competition for control over assets in the sector was between the new entrepreneurs and the sector insiders, each representing a distinct political constituency.

2.6. It was particularly the insiders, interested in maintaining control over large supply networks and chains of stores, who attempted to manipulate the process to their advantage. However, they were blocked by four somewhat independent developments. First, the new restitution laws made plain the possibility that any enterprise assets, particularly retail units, were vulnerable to reprivatization. For insiders, it was unclear which assets would remain to provide the basis for corporatization. Second, the public had little sympathy for the insiders' plight, and newspapers campaigned against insider preferences. As a result, Parliament enacted a program that allowed anyone to propose any asset for sale by auction and granted no preferences to insiders.[4] Coming early in the overall privatization process, this decision was portentous for the complete absence of insider preferences enacted in the subsequent large privatization program, thereby distinguishing the path of privatization in the Czech Republic from the substantial preferences and advantages received by insiders in other post-command economy countries of Eastern Europe. The third development was the start of the small privatization program in January 1991. The Privatization Ministry supported privatizing as much property as rapidly as possible. The policy of "privatization for its own sake" paid little heed to "technocratic" arguments and tended to favor quick approval of the small privatization proposals.[5]

2.7. Finally, some enterprise remnants that survived the onslaughts of restitution and small privatization were corporatized, for inclusion in the large privatization program. Enterprise managers believed that they could maintain control of their companies if the predominant method of transfer was to be voucher privatization.[6] But the situation was drastically altered by the opportunity given to outsiders in late 1991 to submit "competing projects" against the "basic projects" submitted by the insiders and by the outsiders' prompt response (see Section D). Furthermore, the astonishing success of Investment Privatization Funds in early 1992, which in total attracted 72 percent of all voucher points, promised to create a less dispersed share ownership structure and therefore increased the possibilities for effective control, even through voucher privatization.

2.8. The subsequent sections of this country study review the procedures adopted under each of the approaches, the results, and the lessons learned. The processes of transformation and divestment of the cooperative sector are also examined.

B. Restitution

2.9. In response to the strong pressure of public opinion, the Czech Republic developed one of the most extensive programs of restitution among former communist countries. A distinguishing characteristic of Czech restitution is its emphasis on returning specific assets to their former owners, as opposed to providing them with monetary or other compensation; thus, the program is frequently termed "reprivatization."[7]

Restitution Laws

2.10. According to the reprivatization laws,[8] restitution applies only to property nationalized after February 25, 1948, the date on which the communists assumed full control of the Czechoslovak Parliament. Thus, although most industrial assets were effectively excluded from the restitution program, many shops,[9] workshops, restaurants, and hotels, as well as small factories, houses, and plots of land, were eligible for reprivatization.

2.11. Two additional exceptions to the general category of "property nationalized after 1948" are stipulated in the laws. The first exception is financial assets and shares of companies which were eventually nationalized. It was decided that compensation for financial losses of this sort would be

too complicated to administer. The second exception was made on moral grounds: subsequently nationalized property that had been given as a reward for aiding the Nazis was not eligible for reprivatization. In the event that property nationalized after 1948 had later been destroyed, claimants were entitled to receive monetary compensation. Eligibility for participation in the program was limited to resident Czechoslovak citizens whose property was nationalized between February 25, 1948 and January 1, 1990.

The Process of Reprivatization

2.12. The law set deadlines for filing restitution claims, and claimants lost all potential rights if they failed to submit claims before the expiration of these deadlines. Applicants submitted their claims for restitution in the form of a petition directly to the state or cooperative organization using the property in question. If the claim was clearly valid (for example, if only one claimant held proof of previous ownership), the current user was obliged to either return the property to its former owner within 30 days, or within this period sign an agreement with the former owner stating precisely when the property would be returned. The law also stipulates penalties if the current user is responsible for any delay in the return of the property beyond 30 days.

2.13. Disputes regarding restitution claims were referred to district courts. District level governments were entirely responsible for the administration of redistribution and provided both court and notary services to claimants free of charge. In addition to disputes arising from competing claims, disputes between former owners and current users were also brought to the attention of the courts.

Results

2.14. Aside from the former German Democratic Republic, the Czech Republic has developed the most extensive restitution program of all post-communist countries in Central and Eastern Europe. Some 17,000 to 20,000 trade and service establishments are estimated to have been restituted. These figures, however, do not fully reflect the impact of restitution on the transformation of the trade and service sector. First, the restitution of residential houses, which are not included in the numbers mentioned above, created much ground floor space potentially usable by private entrepreneurs.[10] Second, recipients of restituted property suddenly found themselves owning assets which could be used as collateral for obtaining bank credit, including for the purpose of establishing new businesses. The Czech reprivatization program did, however, cause uncertainties and complications for the other privatization programs. The six-month application terms may have somewhat delayed the implementation of both small and large privatization.[11] For example, the restitution of property to more than one owner (which sometimes occurred) led to disagreements over rights of control and property use. While it is not possible to gauge the program's effect on the transformation of the sector with any precision, it seems clear that restitution was a successful political strategy and economic policy. Through the program, the Czech government maintained public interest in privatization and popular support for reform, even during the painful period of macroeconomic stabilization between 1990 and 1991. At the same time, it may also have created a first "critical mass" of private businesses.

C. The Small Privatization Program (SPP)

Objectives

2.15. The small privatization program (SPP) was driven by political motivations mingled with economic arguments. The new government, dominated by "radical," free-market reformers, was eager to demonstrate its ability to carry out reforms and selected trade and services as the first target for privatization. Although other methods have also been significant, the SPP has been the main policy vehicle for the direct transformation of trade and services in the Czech Republic. It has accounted for over half of the trade and service establishments being privatized.

Legal and Organizational Framework

2.16. The law creating the SPP[12] established basic conditions for the selection of assets for the program, auction as the sole method of divestiture, and collection of the revenues in a central fund to be used to pay the debts of parent enterprises. There was a corresponding implementation law,[13] for the regulation of small privatization in the territory of the Czech Republic. The rules governing the execution of public auctions and the tax-free status of auction purchases were set forth in various decrees and announcements.[14]

2.17. Three sets of state institutions have been involved in the program. First, the government and the Privatization Ministry set the broad outlines of the policy and were responsible for the final decision on the sale of each property. Second, the founding ministries (usually the Ministry of Internal Trade and Tourism) and state enterprise managements played a role in the selection of assets. Third, District (*okres*) Privatization Committees were established to recommend assets for the program, publish information about assets and sales, and administer the auctions. The members of these Committees, of which there are 20 to 25 in most districts and 70 to 100 for the city of Prague, are appointed by the Minister of Privatization and include professional employees and representatives of the Privatization Ministry and the local union of entrepreneurs.

2.18. The small privatization program was by no means a detailed plan enumerating precisely which assets would be privatized in the Czech Republic according to a predetermined timetable. The law specifies only that "the subjects of the ownership transfer ... are movable and immovable assets, as a property basis of enterprises that act in the spheres of services, trade, and other areas, excluding agricultural production" (Article 2). The law also excludes properties subject to reprivatization and those owned or used by persons with foreign residency. Two final exclusion criteria played significant roles in the struggles over assets in the program. First, the program excludes those considered "technologically necessary" to the operation of the parent enterprise. Second, all obligations are excluded: the assets are sold "unencumbered."[15] Whether the land and building are sold as part of an asset or are merely leased varies from case to case. Only if the lot of land on which the asset is located is held by a state organization, does the law require that the land and building be sold with the unit, a provision that was not applied in the case of multi-unit structures.

2.19. Unlike the privatization programs in many other countries, the Czech program has imposed few restrictions on the operation of a privatized business. The Small Privatization Law requires only that shops selling groceries must continue such sales for a period of at least one year, and the local government is given the discretionary right to shorten this period. The right of alienation is attenuated to the degree that sales to foreigners are forbidden for a period of two years.[16]

2.20. Given the openness of the law, the determination of the assets to be included in the program was decentralized, relying primarily on local decision-making and initiative. Though District Privatization Committees selected many assets on their own, any person, presumably motivated by the possibility of becoming the new owner, could also propose any eligible asset by submitting a proposal to the Committee. If the Committee approved the proposal, the state enterprise could still attempt to block the privatization by claiming that the unit was "technologically necessary" for the continued operation of the enterprise as a whole. Disputes were resolved in negotiation with the enterprise's founding organ and with the Privatization Ministry, which made the final determination.

2.21. Out of a total of approximately 68,000 trade and service establishments in 1989, it is estimated that 23,272 were privatized through the small privatization program as of the end of 1992. The law also allowed many other types of assets to be sold in the privatization program, including small manufacturing firms, cars, trucks, and warehouses. The number of these items is estimated at 6,779, making altogether a total of some 30,051 assets already sold or scheduled for inclusion in the small privatization program. Annex 2.1 shows a detailed breakdown of all types of assets in this program.

2.22. Of the total of 23,272 trade and service establishments in the program, only about 28 percent are "full privatizations" (i.e., they were or are to be sold with the building and land). In the remaining 72 percent, the auction winner purchases equipment and inventories and receives only the right to rent the premises for a fixed term. The Small Privatization Law fixed the initial rental term for auction winners at two years. Although this is a rather short time horizon for encouraging investment and restructuring, concern over the rights of owners to determine the use of their property seems to have motivated this provision.[17] A later amendment increased the term to five years for subsequent auction winners.

2.23. The fact that the contract with the lessor is signed only after the auction has taken place has cast some potential uncertainty on the object of the bidding. The new business "owners" who have won leasing rights must still negotiate with the premises owner or administrator over the size of rental payments, and the District Privatization Committees play no role in these negotiations. Because rather stringent rent controls apply to business premises as well as to housing, in many cases the maximum amount of rent could be foreseen in

advance of the auction. But the regulations also contained the provision that local governments could choose to increase the ceilings or even allow completely free negotiation. However, the Small Privatization Law gives the auction winner an essentially absolute right to occupy the premises. It is thus difficult to evict such a tenant even for nonpayment of rent.

2.24. Although selection of assets for the small privatization program was largely finished by the end of 1992, the District Committees were still functioning as of late spring 1993, and it was in fact still possible for assets to be proposed for the program. What is remarkable about the asset selection process is that it was accomplished in a decentralized fashion, and primarily through private initiative. The Small Privatization Law merely established a basic legal framework, and allowed individual incentives and seemingly well-functioning institutions to do the rest. Some 30,000 objects were scheduled for auction, with remarkably few problems.

2.25. The equal opportunity for all citizens to participate is a unique feature of the privatization process in the Czech and Slovak Republics, and applies particularly to the small privatization program. Once assets were selected for inclusion in the program, the auctions were open to everyone, with essentially no special preferences, including for insiders. Of course, insiders may have had an informational advantage in both the small and large privatization programs in the Czech Republic, but the absence of lower prices, special credits, and preemptive rights for insiders provides a striking contrast to most privatization programs in other countries of the region.

2.26. In the first round, foreigners are excluded from participating. The rationale for the citizenship restriction is that the program is meant to be a vehicle for the creation of an indigenous business class. Legal persons founded under communism are precluded as well, because their participation could lead to the transfer of the privatized property back into state or cooperative hands. Only legal persons completely owned by natural persons are permitted, and cooperatives of all types are excluded.

The Allocation Process

2.27. The exclusive method of transfer of ownership rights adopted under the small privatization program has been public auctions. Information about the unit to be sold must be announced 30 days in advance of the auction. Prospective buyers may make two visits to the unit for sale, for a fee of Kc 50 (approximately US$1.8) per visit.[18] Auction participants are required to pay a nonrefundable entrance fee of Kc 1,000 (US$36) as well as a refundable deposit of either 10 percent of the starting price or Kc 10,000 (US$360), whichever is higher.

2.28. The starting price is determined as the sum of the values of land, buildings, machinery, equipment, and inventories. Land is appraised on the basis of a simplified technical-economic valuation method from which the Czech Ministry of Finance drew administrative price maps. Book value was used for other assets. Although it is included in the starting price, the cost of the inventories is not part of the purchase price, but instead is paid separately to the state enterprise.

2.29. If no participant is willing to pay the starting price and there are at least five participants, a variant on the "Dutch" auction may be employed in which the price is progressively decreased by amounts of 10 percent. (In a standard Dutch auction, the price is usually progressively lowered until the object is claimed by the first bidder willing to pay the offered price.) If a bid is made during this process, the standard auction procedure, with increasing bids, may be resumed. In the first round, the price can fall to as low as 50 percent of the starting value. For items remaining unsold even after their price has been decreased, a second round may be held in which the price can decrease to 20 percent of the starting price. If there is a foreign participant (which is permitted in the second round), the price may fall to only 50 percent.[19]

Results

2.30. By the end of 1992, 21,786 units had been sold through the small privatization program in the Czech Republic. The monthly sales for 1991 and 1992 are shown in Annex 2.2. The average starting price for all units was Kc 963,000 (US$33,200), while the average final price reached Kc 1,451,000 (US$50,000), or 51 percent higher than the starting price (see Annex 2.3). In all, 6,262 units (29 percent of the total) were sold with premises, while 15,524 items (71 percent of the total) were sold without premises. Dutch auctions were used to sell 3,453 items (15.8 percent of the total). The average starting price for those units was Kc 2,537,000 (US$87,500) and the average final price was Kc

1,344,000 (US$46,300), on average 53 percent of the starting price.

2.31. It is interesting to note that the lack of special preferences for employees does not imply that few former employees acquired the units in which they worked. A random sample of 100 units yielded 53 units whose owners had worked in the units prior to privatization.[20] Former employees may have inside information about the value of the assets, and thus it should not be surprising that they have won about half the auctions.

2.32. Several problems have been identified that are associated with the execution of the program or that involve some aspects of the ownership rights over the assets being transferred. The first concerns the length of rental agreements for premises in transfers in which real estate was not sold. According to the Small Privatization Law, the winner of a lease auction that did not include premises acquired the right only to a two-year rental agreement. This clearly raised an incentive problem by shortening the lessee's time horizon. Beginning in October 1991, new leases were signed for an obligatory five-year period. A second problem arose from the liabilities left behind in the parent enterprise by the auctioning of unencumbered single units. The law stipulates that for two years the proceeds of small privatization auctions can be used for the satisfaction of claims arising as a result of the law. However, the delay in completion of the process has created problems for the holders of debt. Third, the sale of inventories together with other assets created possibilities for manipulation of the inventory value in the period between the auction and the moment when the new owner took possession. The law stipulated that the inventory levels and prices cannot differ significantly from the date of sale, but this is difficult to enforce in practice. Anecdotes abound of new owners finding useless, damaged, or low quality inventories, for which they are expected to pay.

2.33. A fourth problem arose from the scarcity of equity capital and the poor availability of credit. Credit conditions for the privatization auctions were quite restrictive. There was vigorous competition for less valuable assets from liquidity-constrained investors interested in creating a family business. In comparison with a situation in which there were well-functioning capital markets, the resultant demand pattern may have raised the relative price of smaller, less valuable items, because few citizens were able to participate in the purchase of larger, more valuable ones.

2.34. Finally, although auctions in general seem to offer the best chance for equal participation of all interested parties, and the least opportunity for corruption, there seems to have been collusion among bidders in a fair number of cases, owing to the requirement that at least five participants be present for a Dutch auction to be held. Other irregularities included the purposeful overbidding by a participant with insufficient capital, who would then forfeit the deposit in order to have more time to raise more capital to win the auction in the second round. Nonetheless, the Czech small privatization program seems to have been remarkably successful in avoiding major scandals and in reallocating control over a large number of shop premises in a short period of time.

D. The Large Privatization Program (LPP)

Introduction

2.35. The large privatization program (LPP)[21] employs a wide variety of methods of property transfer, including "standard methods" of auctions, tenders, and direct sales, as well as free transfer through the "non-standard" voucher program. In contrast to the restitution and small privatization programs, the LPP embraces going concerns and shares in corporatized enterprises, in addition to unencumbered assets. The organization of the program is quite complex. This report limits the discussion chiefly to those aspects of large privatization which directly concern the trade and service sector of the economy.

Identification of Assets for Privatization

2.36. The identification of assets through the large privatization program began in mid-1991. The government classified all state enterprises into the categories of those to be retained by the state, those to be liquidated, and those to be privatized in the first and the second "waves" of large privatization. This allocation covered all state-owned enterprises in the Czech Republic, although later splitting of companies altered the numbers in each category.

2.37. Not all of the assets belonging to the enterprises designated for large privatization were included in the program. Trade enterprises in particular lost large numbers of assets both to reprivatization and to the small privatization program. The allocation between the small and the large privatization programs has been a major source

of conflict in the struggle for control over assets in the sector. Because in principle any asset could be proposed for small privatization, the inclusion of an asset in large privatization implied one of two conditions. First, no one had proposed its inclusion in small privatization. Second, the Privatization Ministry sometimes ruled against small privatization proposals when they did occur, usually in response to active lobbying by trade enterprise insiders on behalf of particularly valuable assets. In either case, the enterprise retained the asset for the large privatization program. Thus, although small privatization mostly included "smaller" assets and large privatization included "larger" ones, it is difficult to assess whether the types of trade and service assets differed systematically across the two programs. All together, only 2,000 trade and service establishments were privatized via the LPP, or less than 5 percent of total trade and service establishments.

2.38. Three features distinguish large privatization from small privatization. The first is that large privatization can involve the transfer of whole enterprises or groups of assets, including those joined together in a single joint stock company. The second is that assets can be privatized with obligations and as going concerns. The third involves the use of a variety of methods of transfer including the voucher method and direct sales.

2.39. Each of these features played a role in the negotiations between insiders and privatization officials over the division of assets between the small privatization and large privatization programs. Perhaps the most common argument employed by insiders in favor of large privatization was the claim that a certain unit (or group of units) made an essential contribution to the operation of the enterprise, without which the entire network would lose viability. Concerning the second feature, it is plausible that managers were able to exclude assets from small privatization by manipulating the profiles of their units. The Small Privatization Law states that only "movable and non-movable property" qualifies for sale in the program, effectively eliminating obligations such as contracts, leases, debts, and apprenticeship responsibilities. On the other hand, since large privatization can transfer going concerns as well as individual assets, it could be argued that units tied to obligations or unusually heavy financial responsibilities might be transferred more easily in large privatization. By diverting units away from small and into large privatization, managers could increase the probability that the assets would be privatized through a method which preserved their control. As is discussed later in this section, managers may have been particularly predisposed toward voucher privatization, believing that widely dispersed ownership would result in ineffective corporate governance.

2.40. Among the trade and service sector projects approved for large privatization as of the end of 1992, the largest categories, measured in terms of employment, are hotels, department stores, and wholesale trade stores. As was noted above, the large privatization program allows for the employment of a variety of privatization methods. "Standard" techniques of auction, tender, and direct sale, conforming closely to Western practice, may be applied to assets, with or without attached obligations. Whole state enterprises or their sub-units may be converted into corporate entities and their shares sold to foreign and domestic investors. Some shares are reserved for compensation (restitution),[22] and both assets and shares may be transferred to various funds and to municipalities. Finally, "non-standard" voucher privatization, which involves the exchange of shares in corporatized enterprises for vouchers with which citizens and private funds place bids in a multi-round allocation process, is also allowed. In addition to these methods of privatization, shares may be retained permanently or temporarily in the Fund of National Property (FNP).

The Choice of Method for Privatization

2.41. The choice of the particular method or combination of methods for privatizing a given enterprise involves selecting a "privatization project" from proposals submitted by enterprise managers or any other interested parties. The management of any enterprise subject to large privatization was required to submit a "basic project" first to the founding organ and then to the Privatization Ministry. Basic projects included a business plan and a proposal specifying which parts of the enterprise should be privatized through which method. In addition, any other interested parties could submit "competing projects," which did not necessarily contain privatization plans for the entire enterprise but could focus on the privatization of individual units or groups of assets.

2.42. Although the Privatization Ministry is officially responsible for making the final choice of project or combination of projects to apply to each

enterprise in the program, the District Privatization Commissions have often played a significant role as well.[23] The Ministry typically sends projects to the local commissions for review and, according to some estimates, accepts between 70 and 80 percent of their recommendations. It also appears that the founding organs (typically branch ministries, but sometimes local governments) became more influential in project evaluation in late 1992.

2.43. Although auctions in this program generally follow the same procedures as those conducted in small privatization, the FNP occasionally limits access to participation. In auctions of optician shops and pharmacies, for instance, bids were accepted only from registered opticians and pharmacists, respectively. The FNP also occasionally attaches restrictions on changes in the line of business for assets auctioned in large privatization; for example, in pharmacies the activity must be maintained for at least ten years.

2.44. Tenders are usually evaluated according to three criteria: willingness to assume liabilities, commitment to maintaining the same line of activity, and price. Since virtually all tender bids include the first two criteria (bids without them are refused almost automatically), it seems that price is by and large the decisive factor. Although investment promises and employment guarantees have been important in some widely publicized directly negotiated sales, they are not standard criteria in most tenders. Tenders are thus essentially sealed bid first-price auctions. The evaluating committee is appointed by the FNP, with a representative from the District Privatization Commission. Employing arguments about non-price criteria, FNP officials have occasionally interfered directly in the tender outcome. The ensuing allegations of corruption illustrate the pitfalls of the non-transparency of the tender method.

2.45. It is interesting to speculate on the motives of the individuals submitting projects. Managers may have hoped to influence the process to their advantage by proposing methods of privatization which would allow them to retain some measure of control. The managers may therefore have viewed voucher privatization as attractive, insofar as it could be expected to result in dispersed ownership across large numbers of shareholders, who would be unable to exercise effective corporate governance. "Outsiders" on the other hand tried to acquire assets through large privatization, proposing alternative methods of privatization in their competing projects. The government commitment to involving entrepreneurs in the program by encouraging the submission of competing projects was particularly significant in the case of trade and service sector assets, because of the prospects for growth and relatively low capital requirements in this sector. Potential investors in these assets would have been likely to favor direct sales and other standard methods.

Results

2.46. Although they are nowhere precisely defined, the preferences of the Privatization Ministry concerning alternative methods of privatization become clearer over time. The Ministry favored small over large privatization in 1991, a preference that diminished in 1992. This choice also reflected the preference for relatively transparent, competitive methods over direct sales. In choosing among alternative methods within large privatization, the Ministry's priorities regarding vouchers versus other methods are more difficult to assess. But a huge and largely unexpected increase in demand for participation in the voucher program in early 1992 decreased the average value of property that each voucher holder could expect to receive.[24] The Ministry therefore began to place a higher priority on voucher privatization relative to other methods, and on large privatization relative to small privatization, in order to increase the value of assets backing the vouchers. At the same time, the possibility of generating significant revenues from auctions and direct sales may also have influenced the Ministry's preferences for sales over transfers and voucher privatization.

2.47. By far the most important privatization method applied in the trade and service sector is voucher privatization, with 42 percent of the total book value. Direct sales account for 21 percent, share transfers 20 percent, and auctions an additional 7 percent. Vouchers are particularly important in wholesale trade stores, restaurants, travel agencies, and other services; auctions predominate in warehouses; direct sales are important in warehouses, supermarkets (see the discussion concerning foreign investors, below), and department stores; and share transfers are most significant in travel agencies and hotels. Information about the privatization of Czech wholesale trade is particularly scarce. Although some wholesale units (primarily warehouses) were auctioned under the small privatization program, it seems that the newest and most valuable wholesale trade assets were included in

large privatization, accounting for approximately 50 percent of all storage capacity in the Czech Republic.[25]

2.48. Although no general restrictions exist on who may purchase shares of corporatized companies, or on who may participate in direct sales, auctions, or tenders, participation in voucher privatization is limited to resident Czech citizens over the age of 18, who purchased and registered voucher booklets. They could choose to bid their voucher points as individual investors or to place them with privately created investment privatization funds, which would then use them to bid for the shares of companies in the program. The funds attracted over 72 percent of all points, and the largest 13 control 40 percent of the total.

2.49. Though it may have played only a modest role in the privatization of the sector as a whole, foreign investment has been responsible for several well-publicized direct sales. Through five direct purchases and one majority stake acquisition in the large privatization program, and the purchase of one cooperatively owned establishment (in an excellent location on the Wenceslaus Square in downtown Prague), the U.S. company K-Mart has created a chain of large department stores in all of the largest cities in the Czech Republic. Other major investors in Czech trade and services include Sara Lee of Holland and Tchibo of Germany, both in coffee, and Delhaize Le Lion of Belgium, in supermarkets.

2.50. Thus, some of the trade and service sector, including about 2,000 establishments according to our estimates, is undergoing privatization in groups, thereby preserving to some degree the chains of their progenitor state enterprises. In this respect, the Czech Republic stands midway between Poland and Hungary.

E. Transformation of Trade Cooperatives

2.51. Since 1989, the cooperative sector of the Czech economy has undergone several types of transformation.[26] Legally, cooperatives have been the subject of three separate laws, enacted in 1990, 1991, and 1992. This legislation enhanced cooperative members' rights, cut obligatory ties between district cooperatives and the Union of Consumer Cooperatives, and freed cooperatives to dispose of their assets without governmental approval. However, decentralization of cooperative decision-making may have been less significant than were the provisions that served to support entrenched cooperative leaders. The net result of the changing legal environment may, ironically, have been the maintenance of the organizational status quo.

2.52. In addition to the legal changes, economic circumstances forced cooperatives to alter their operations. Most cooperatives have adopted some mixture of three different strategies to improve their financial condition: (1) leasing of property; (2) sale of property; and (3) alterations in the management of cooperative-run stores.

2.53. The transformation of the cooperative sector can be divided, broadly, into two processes. One, the legally required process by which cooperatives were made to conform to new regulations before the end of January 1993, will be called the "legal transformation process." The second process, whereby individual cooperatives are leasing and selling their commercial premises, will be referred to as "cooperative divestment." The question of which of these two processes is the more important is related to the terminological problem in defining the scope of cooperative "transformation." The difficulty stems from the partially state, partially private character of these cooperatives. In one sense, cooperative transformation occurs when what may be called the "pseudo-cooperative sector" is disassociated from the state apparatus, and "authentic" cooperatives take the place of state-controlled cooperatives. In this sense, transformation occurs primarily as a result of actions taken by state authorities and the ensuing reconfiguration of the relationship between cooperative officials and members. It has little to do with control over individual assets. Cooperative transformation can thus be viewed as basically equivalent to alterations in the legal regime regulating cooperatives. Alternatively, transformation can be seen as the transfer of assets from cooperatives to non-cooperative parties. With this perspective, the identity of the buyers and sellers of assets and the extent of the property rights being transferred are of the greatest interest, and cooperative transformation is essentially analogous to the privatization of state assets. Because both sets of developments are central to the evolutionary process, we have elected to use the term "cooperative transformation" to encompass both processes.

Legal Transformation Process

2.54. The evolution of cooperative regulation has been tied to larger political developments in post-communist Czechoslovakia. Legislation prior to 1990 did not affect the overall organization of the

cooperative sector. The Union of Consumer Cooperatives still directed the activities of each of the 73 local cooperatives and integrated the activities of consumer cooperatives with those of other cooperatives and state enterprises. New legislation, effective in 1990, produced two categories of reforms: reforms affecting relative power within a given cooperative, and reforms influencing the relationship between local cooperatives and outside parties.

2.55. Internal reform occurred through facilitation of the movement of capital assets within cooperatives. Assets were shifted to increase share values, which empowered members and also provided an impetus for them to monitor cooperative activities. The 1990 legislation made membership in the national cooperative unions voluntary, thereby increasing the autonomy of individual cooperatives. Also, the requirement for governmental approval of sale of local cooperative assets was abolished. The first freely elected government, seated in mid-1990, empowered members to assert their democratic rights and the control of their cooperatives.

2.56. Cooperatives, like all other legal forms, were initially regulated by the Commercial Code of 1991.[27] Provisions pertaining to cooperatives remained essentially unchanged from those in the 1990 law. Cooperative property was not treated as analogous to state property. However, the "Transformation Law"[28] required cooperatives to go through a special process to ensure that their internal by-laws were in accordance with Code provisions. The law required that all cooperatives either be transformed by January 28,1993 to conform to the structure prescribed under the Commercial Code or be liquidated. Both the Transformation Law and the Commercial Code in fact heavily promoted the maintenance of the existing cooperative structures. First, the Transformation Law included a provision that both minimized the revaluation of cooperative membership shares and de facto ruled out the liquidation of cooperatives. Each cooperative was required to set aside 75 percent of its assets in an "indivisible fund." If the cooperative were to be liquidated within the ten years following the adoption of the law, the entirety of the indivisible fund (remaining after debts are paid) would be transferred to the Fund for National Property. While the Transformation Law ensured that cooperative assets would not be distributed through liquidation, the Commercial Code ensured that cooperatives were not split up into other legal forms. Cooperatives were allowed to divide their assets to form other economic organizations, but the Code permitted their division only into other cooperatives. The Commercial Code therefore mandated that cooperatives remain cooperatives.

Divestment of Assets

2.57. Market reforms, the entry of a large number of new private competitors, and the financial interests of members led cooperatives to divest ownership of a majority of their assets through a variety of different processes, some passive and some active. Restitution, for instance, was outside of the control of cooperatives. On the other hand, cooperative sales, leasing, and abandonment were processes actively initiated by cooperatives.

2.58. As of spring 1993, cooperatives continued to run 7,089 of the 26,250 shops and catering establishments operated in 1989. Out of the 19,161 businesses which are no longer operated by cooperatives, an estimated 3,500 units were lost through restitution, and an additional 3,972 businesses are currently leased to private individuals.[29] The remaining approximately 11,700 premises have been sold, ceded to municipalities, or abandoned. There is, unfortunately, no reliable way to further subdivide this number. Nonetheless, the movement of over 19,000 premises out of the control of consumer cooperatives makes cooperative divestment one of the most significant retail sector transformation processes in the Czech Republic. All pre-1989 cooperatives continue to exist but they do so with far fewer members. Cooperative membership slipped from 1.42 million in 1989 to 840,000 at the end of 1992. As of March 1993, consumer cooperatives were leasing out 2,768 shops and 1,204 restaurants to private parties. While complete information about lease conditions cannot be obtained, a Privatization Project case study reveals the existence of two types of leasing arrangements.[30] Less desirable units were rented for a defined period with few lease conditions. In a second group of stores, the lease contract was similar to a franchise arrangement. Lessees were required to maintain the business name and to purchase the same goods from a defined supplier.[31]

2.59. At the end of the "legal transformation process," consumer cooperatives in 1993 bore a striking resemblance to their 1989 forebears, although they were not identical. Most members are largely passive, but a core group continues to have strong incentives to participate actively in cooperative management. Members who are cooperative officials and employees (all employees are coopera-

tive members) have significant economic interests in cooperative functions.

2.60. All consumer cooperatives continue to be members of the Union of Czech and Moravian Consumer Cooperatives, but the Union's function has been significantly altered. Previously, the Union served as the managerial center of the cooperative sector, largely controlling the actions of local cooperatives. It now serves as a source of technical support for member cooperatives. In addition, cooperatives are making a concerted effort to support each other. After an initial period in 1990-91 when local cooperatives sought to establish their independence, cooperatives are actively pursuing strategies, coordinated by the Union, to promote the cooperative sector. Cooperative officials estimate that cooperative stores purchase 50 percent of their supplies from other cooperatives, a significant increase from the 30 to 40 percent level of intra-cooperative sourcing in the pre-1989 period.[32] The creation of a Cooperative Bank and the attempt to form a central cooperative purchasing agent are evidence of the efforts to establish stronger economic links among cooperatives.

2.61. Cooperatives exist today as the single remaining owners and operators of substantial retail networks in the Czech Republic. The advantage that cooperatives hold over independent, individual business establishments in terms of economies of scale, negotiating power, and access to capital could prove to be significant in the future development of the Czech retail sector.

Notes

1. Data for the nearly 3,000 hotels (plus motels, pensions, and camps) do not permit the classification of these units by ownership, and the 2,000 service units of municipalities were seriously undercounted, since many service units existing at the time were integrated into larger enterprises conducting other activities.
2. In the Czech Republic, as in other post-communist countries, there was no doubt also some "spontaneous privatization," whereby enterprise managers sold or transferred assets to the private sector and/or out of state control. The most obvious transactions were forbidden after March 1991, but it is speculated that a large number of assets may have been sold until that date.
3. Many of the premises used by cooperatives in rural areas were actually owned by local governments, which have in numerous cases recently reclaimed their ownership rights.
4. Insiders were not prohibited from participating in the small privatization program. The results of our establishment survey, discussed in this report, indicate that about half the small privatization auctions were won by former shop employees. Although we have no data on the extent to which former Ministry of Trade officials or enterprise managers became new owners, it seems that insiders may have been able to use their informational advantages to retain some of their former control.
5. Any asset was fair game to be proposed for small privatization until the Privatization Ministry gave final approval to a large privatization project containing that asset. In 1992, the Ministry partially reversed its priorities to increase the supply of assets to the voucher program.
6. They may also have attempted to arrange sweetheart deals with outside investors, or even to acquire the assets directly themselves, but such possibilities were constrained by the requirement for approval from the Privatization Ministry.
7. By avoiding the need to determine the value of formerly confiscated property, reprivatization may be much simpler than compensation. The problems of reprivatization in determining legal ownership, on the other hand, are avoided with compensation. The Czech program does use compensation in some situations, for instance for destroyed property.
8. Two principal laws and amendments to these laws now regulate the restitution of property in the retail trade, catering, and services sector of the Czech economy: Law No. 403/1990 "On Relieving the Consequences of Some Property Injustices" (Small Restitution) and its amendments, and Law No. 87/1991 "On Out-of-Court Rehabilitation" (Large Restitution).
9. Among these shops were many nationalized family businesses, attached to the living quarters of the previous owners. They were perhaps the easiest to privatize through restitution. In many cases not only was there a single, undisputed, previous owner, but quite often that previous owner was still living on the premises and still operating the shop.
10. As a qualifier, we should point out that although there are no restrictions on the use of restituted property in particular, there exist rent controls and eviction regulations on property which has been used as residential space, which also affect the use of restituted property for business purposes. It seems that rent ceilings are so low, and the restrictions on tenant evictions so stringent, that available ground floor business space has remained extremely tight.
11. Although the argument that restitution would stall other "quick" privatization (small and large privatization) schemes was one of the most important objections to a restitution program, neither small nor large privatization has proceeded as quickly as originally had been hoped.
12. Law No. 427/1990, Coll., "On the Transfer of State Ownership of Certain Properties to Other Legal or Natural Persons."
13. Law No. 500/1990 Coll., "On Competencies of Czech Republic Governmental Bodies in the Matter of Transfer of State Property to Some Things to Other Legal or Physical Persons."
14. The rules for public auctions were stipulated in Decree of the Ministry of Privatization No. 535, and the tax-free status of auction purchases was announced by Federal Ministry of Finance Announcement No. 90/1990/1 Coll., "On the Tax-Free Status of Auction Purchases."

15. The provision that units with liabilities could be privatized only in the large privatization program may be considered the most important legal distinction between the kinds of assets covered by the two programs.
16. This is true if the auction is completed in one round, which implies that the purchaser must be a citizen. If the auction requires multiple rounds, which allows the possibility of a foreign purchaser, then the resale restriction no longer applies.
17. Among these owners are restituents, to whom many business premises were returned and who have now become lessors, and municipalities, to which many premises have been transferred. The transfers to municipalities take place under Law 172/1991, according to which municipalities have restitution rights to property they owned prior to 1949. This law also allows municipalities to apply to the Ministry of Finance to receive any state-owned property. Municipalities have become important landlords, although as business operators they are much less important than formerly.
18. We use the exchange rate of US$1 = Kc 28, which has been roughly constant over the 1991-93 period.
19. Because of suspected collusion among bidders, the procedure was amended in 1992 to permit the price to fall only in the second round and only to 50 percent of the starting price, in the case of sales of premises.
20. This random sample was taken from the total 15,231 retail trade, catering, and service units already sold as of December 12, 1991 (see Chapter V, Survey).
21. Initiated by Law No. 92/1991, "On Conditions and Terms Governing the Transfer of State Property to Other Persons."
22. These shares are distributed as compensation to those entitled to reprivatization under the restitution laws but whose expropriated property was destroyed during the period of state control.
23. During the first wave of large privatization, the District Privatization Commissions were occupied with the administration of small privatization auctions, the purpose for which they were created. Since the volume of small privatization sales began to dwindle in late 1992, the District Commissions have begun to assume a larger role in large privatization, often executing auctions and participating in the evaluation of tenders.
24. Although less than a half million voucher holders were registered at the end of 1991, participation soared in January 1992, with 8.57 million registered by the end of February, the final deadline. This unexpected increase is usually attributed to the spectacular offers by Investment Privatization Funds of guaranteed 900 percent rates of return.
25. Based on evidence collected during an interview with the Czech Ministry of Industry and Trade, in May 1993.
26. Consumer cooperatives were not the only cooperative form operating in the retail trade and service sector. Producer cooperatives were also significant providers of services. However, the inadequacy of the data on service units in the Czech Republic precludes analytical study. This section will, therefore, deal exclusively with consumer cooperatives.
27. Law No. 513/1991.
28. Law No. 42/1992, the Law on the Regulation of Property Relations in Cooperatives.
29. Unpublished statistics, Union of Czech and Moravian Consumer Cooperatives.
30. The case study was conducted on a consumer cooperative operating 98 retail stores, with 15,465 members.
31. Lessees had the right to select their own suppliers for any additional goods they chose to sell.
32. Privatization Project interview with the Union of Czech and Moravian Consumer Cooperatives (May 12, 1993).

Annex 2.1:
Czech Republic: Structure of Items Scheduled for Small Privatization as of December 31, 1992

		Total No. of Items	No. of Items with Premises	No. of Items without Premises
Retail Trade Shops		**15,452**	**3,727**	**11,725**
Of which:	Sweets, candies	321	262	59
	Household necessities	2,409	419	1,990
	Kiosks	654	70	584
	Newspapers and tobacco	2,462	40	2,422
	Shoes and leather	305	52	253
	Department stores	70	63	7
	Food shops	3,903	1,828	2,075
	Books, old prints	337	16	321
	Furniture	107	36	71
	Florists	405	53	352
	Textiles and clothing	1,404	177	1,227
	Butchers	912	158	754
	Vegetables, fruits	1,271	328	949
	Bakeries	128	111	17
	Petrol stations	165	133	32
	Other shops	599	190	409
Restaurants		**2,424**	**911**	**1,513**
Services		**5,396**	**1,831**	**3,565**
Of which:	Hotels	577	489	88
	Other services	4,819	1,342	3,477
Other Items		**6,799**	**1,497**	**5,282**
Of which:	Cars, means of transport	4,020	46	3,974
	Warehouses	592	389	203
	Production units	730	357	373
	Factories	211	152	59
	Houses and offices	269	206	63
	Transportation	77	27	50
	Cultural houses	34	22	12
	Computer centers	8	1	7
	Others	838	297	541
Total		**30,051**	**7,966**	**22,085**

Source: Ministry of Privatization.

Annex 2.2:
Czech Republic: Number of Items Sold in Small Privatization, 1991-92
(All items)

Month	Year	Number of Units	Cumulative Number of Units	Average Starting Price in Kc 1,000	Average Final Price in Kc 1,000	Ratio of Final Price to Average Price (%)
January	1991	16	16	139	1,365	982
February	1991	69	85	163	290	178
March	1991	829	914	302	549	182
April	1991	1,831	2,745	407	647	159
May	1991	1,709	4,454	436	612	140
June	1991	2,307	6,761	742	1,014	137
July	1991	1,221	7,982	885	1,236	140
August	1991	1,414	9,396	1,051	1,217	116
September	1991	1,622	11,018	916	1,308	143
October	1991	1,897	12,915	1,624	2,447	151
November	1991	1,293	14,208	558	1,192	214
December	1991	1,023	15,231	637	1,622	255
January	1992	1,074	16,305	1,013	1,765	174
February	1992	904	17,209	1,507	2,258	150
March	1992	802	18,011	1,142	1,871	164
April	1992	759	18,770	1,151	1,719	149
May	1992	767	19,537	1,214	1,582	130
June	1992	611	20,148	1,625	1,844	113
July	1992	395	20,543	1,579	2,270	144
August	1992	329	20,872	1,962	2,714	138
September	1992	303	21,175	1,799	2,957	164
October	1992	286	21,461	1,602	2,536	158
November	1992	177	21,638	1,626	2,935	181
December	1992	148	21,786	1,878	2,358	126

Source: Ministry of Privatization.

Annex 2.3:
Czech Republic: Structure of Items Sold in Small Privatization as of December 31, 1992

		Total No. of Items	Average Starting Price in Kc 1,000	Average Final Price in Kc 1,000	Ratio of Final Price to Average Price (%)
Retail Trade Shops		**12,782**	**671**	**1,185**	**177**
Of which:	Sweets, candies	271	449	1,051	234
	Household necessities	1,998	437	993	227
	Kiosks	462	254	321	126
	Newspapers and tobacco	2,230	26	187	718
	Shoes and leather	176	335	554	170
	Department stores	54	15,014	20,965	140
	Food shops	3,357	1,194	1,814	152
	Books, old prints	259	113	554	488
	Furniture	84	1,299	2,689	207
	Florists	335	139	670	483
	Textiles and clothing	1,107	358	968	270
	Butchers	763	401	841	210
	Vegetables, fruits	1,076	397	732	184
	Bakeries	99	4,315	5,630	130
	Petrol stations	119	1,175	4,217	359
	Other shops	392	1,511	2,133	141
Restaurants		**1,824**	**1,146**	**1,791**	**156**
Services		**3,936**	**1,131**	**1,498**	**132**
Of which:	Hotels	427	3,576	5,939	166
	Other services	3,509	833	958	115
Other Items		**3,244**	**1,823**	**2,253**	**124**
Of which:	Cars, means of transport	1,528	174	158	91
	Warehouses	422	2,416	2,830	117
	Production units	482	3,515	3,399	97
	Factories	136	11,280	16,186	143
	Houses and offices	157	1,105	1,914	173
	Transportation units	41	4,121	4,138	100
	Cultural houses	17	1,194	925	77
	Computer centers	3	969	822	85
	Others	458	2,261	3,375	149
Total		**21,786**	**963**	**1,451**	**151**

Source: Ministry of Privatization.

Chapter Three

Poland

A. Introduction

3.1. Poland has achieved the most rapid transformation of the retail, catering, and service sectors in all of Central and Eastern Europe. Officially, over 97 percent of all shops and other consumer outlets in Poland are now private; although these statistics are not fully reliable, the extent of the transformation is undeniably high. Perhaps the most interesting fact about the small-scale privatization in Poland is that the government never mandated or legislated its occurrence. In contrast to other countries, in Poland there was no separate small privatization "program," and the impact of the general privatization law was minimal. Instead, a series of governmental acts, unrelated to privatization per se, released a spontaneous and largely unregulated process in which the existing special interests were pitted against each other and were enlisted in the cause of transformation. While many aspects of the rapid change in Poland can be attributed to the macroeconomic reforms introduced in January 1990, and while other aspects may be due to unique local conditions, the "case of Poland" contains important lessons for other countries that are restructuring their consumer sectors, especially the newly emerging nations of the former Soviet Union (FSU).

Transfer of Real Estate

3.2. The key to the rapid rate of small privatization in Poland has been the realization on the part of the government that the transformation of retail trade, catering, and consumer services centered not around the privatization of the substandard businesses run by the command economy's domestic trade sector, but around a *transfer of the real estate* on which these businesses had been operated. Thus, the salient features of small privatization in Poland had little to do with a transfer of ownership in businesses as "going concerns," or with ensuring the continuity of operation of old state-run stores and outlets. The essence of small privatization in Poland was a transfer of interests in commercial premises to private parties. While these interests were most often narrower than full ownership rights, all laws, regulations, and policy prescriptions created to govern the transfer of the use of real estate shared a common theme, namely, the harnessing of private initiative for the purpose of creating market conditions of access to commercial property.

3.3. The implicit objective of governmental policy measures was to dissolve the state-run trade network, not to preserve it. Insofar as the retail units themselves were concerned, there was little of value in them beyond the premises that could be used productively in the aftermath of the transfer. Given the impoverished state of the sector, the equipment of state and cooperative stores was not worth very much, and the inventory was either nonexistent or so substandard that even the chronic shortages of the command economy period had not sufficed to get rid of it. With the new influx of imported goods[1] and rapidly rising consumer expectations, the inventory was in fact likely to become a liability.

3.4. Two consequences followed from this focus on real-estate utilization. First, since the old stores and outlets were essentially "stripped" to their real-estate skeletons, and since the new businesses as much as the old ones needed access to largely state-controlled commercial premises, the distinction between "start-up" and "privatized" units became rather fluid. While most of the new businesses were undoubtedly private, the state has often preserved its title to the premises on which both the new and the "privatized" units are operated, with the businesses usually acquiring only highly restricted, short-term use rights. The main feature of small privatization in Poland, then, has been not a conferral of important property rights on private parties, but rather a destruction of the old system in which large socialized enterprises controlled the most valuable real estate necessary for the development of a genuinely private retail trade sector.

3.5. The second consequence of the focus on real estate was the ability of policy makers to bypass the old state domestic trade organizations (consumer cooperatives and state enterprises), which were not interested in construction and ownership of premises in which their stores were located, but instead leased them at low prices from other state institutions and housing cooperatives. Thus, the ownership of real estate was in most cases separated from the ownership of retail businesses, but this fact was without significance as long as the allocation of commercial space was based on planning decisions rather than market mechanisms. One of the early acts of the Mazowiecki government, however, was to restore genuine property rights to the previous merely titular owners of real estate. The local governments and housing cooperatives, the main beneficiaries of this change, had no interest in preserving the old empires of state trade organizations, which had been run on a centralized basis and had maintained no real ties to the local communities. For the newly enfranchised owners of real estate, the only potential obstacles to their takeover of state and cooperative stores, particularly in the case of local authorities, were the employees of the local units, who had local connections and the sympathy of their neighbors. The result was an alliance between local authorities and the insiders from the affected units, who turned against their old employers and went into business for themselves.

3.6. State enterprises were thus deprived of most of their stores, and consumer cooperatives suffered very significant losses as well. The near-mortal blow was delivered with astonishing speed, and the large trade organizations, which in the other countries (with the possible exception of former Czechoslovakia) have very effectively resisted a radical restructuring of their sector, were weakened beyond repair. While the "surgical" removal of the premises owned by local authorities and housing cooperatives was accomplished with great efficiency, the privatization of the remaining retail and service units in the former socialized sector was a much more difficult and somewhat less successful operation. This process took different forms in the state and cooperative sectors.

3.7. The privatization of the rump state enterprises has been the only part of small privatization that took place according to the more general procedures prescribed by the Polish Privatization Law. The dominant form of transformation here has been the so-called "privatization through liquidation," which involves a sale or lease of enterprise assets to a company formed by the employees. Although it is the most decentralized of the Polish privatization programs, it is fairly tightly controlled by the founding organ (most commonly the voivoda office)[2] and the Ministry of Privatization, and its progress in the domestic trade sector has been slow.

3.8. The privatization of the consumer cooperative sector, which controlled the greatest number of stores in Poland, is the most complex and the least studied part of Polish small privatization. Privatization of this sector began immediately after the fall of the last communist government, with a law dissolving central and regional associations of cooperatives. The dissolution of the associations had a twofold impact on the development of small privatization. First, the liquidators appointed to manage the dissolution process were charged with disposing of the property of the associations. This led to a large-scale release of assets crucial to the formation of private wholesale and distribution systems, and contributed a very important element of "upstream" restructuring. Second, the dissolution of cooperative associations essentially decapitated the state-dominated cooperative system, and set local cooperatives adrift.

3.9. The elimination of the associations and the loss of units as a result of the termination of old administrative leases opened the door to a decentralized process of transformation for local cooperatives. Large numbers of cooperative units were effectively privatized by being leased or franchised to private individuals, most often member-employees. Other units are still run by the cooperatives

themselves, but they too have been "privatized" with a stroke of a bureaucrat's pen: they were simply reclassified as no longer belonging to the "socialized" sector.

Insider Domination

3.10. As is obvious from what has been said, the process of small privatization in Poland has been dominated by the employees of the former state and cooperative units and by local government insiders, with the central government skillfully manipulating the incentives of all parties. An overwhelming majority of the previously socialized units (or the premises on which they were located) have accordingly been allocated on the basis of a closed procedure and at prices that most often have not reflected their market value. Insider domination in part explains the speed with which small privatization was achieved in Poland, and this may provide an important lesson for other countries. Unless the government is extremely strong and insiders are incapable of mounting effective resistance (which seems not to be the case in most post-command economy countries), there is a clear trade-off between the speed of small privatization and an open, competitive method of allocation. But the problems raised by insider domination are also serious, since insiders are less likely to restructure and invest in the newly privatized businesses.[3] The results of the survey show that post-privatization investment levels in Poland are significantly lower than in Hungary or the Czech Republic.

Scope of the Transformation

3.11. The extent of transformation of Poland's retail and service sectors is analyzed in Table 3.1. In aggregate, between 1989 and 1992 the number of socialized retail, catering, and service outlets de-

Table 3.1:
Poland: Ownership Transformation in Retail Trade, Consumer, and Service Sectors
(Thousands of Units)

	1989	1992	% Change
Total Retail Outlets[1]	**249**	**750[2]**	**301**
Socialized	178	33	(82)
Private	72	717	996
Total Retail Shops	**151**	**353[2]**	**234**
Socialized	124	9	(93)
Private	27	344[3]	1,267
Total Catering Outlets	**31**	**53**	**171**
Socialized	16	1	(94)
Private	15	52	347
Total Service Outlets	**255**	**209**	**(18)**
Socialized	42	8	(81)
Private	213	201	(6)
Total Outlets in Retail, Catering, and Service Sectors	**535**	**1,012**	**189**
Total Socialized	236	42	(82)
Total Private	300	970	323

[1] Outlets include shops as well as kiosks, stands, booths, and other small points of sale.
[2] Estimated by GUS from a preliminary tally of year-end statistical reports.
[3] Includes approximately 46,000 stores run by cooperatives and other social organizations.

Sources: GUS *Statistical Yearbooks* 1989-92; Institute of Internal Market; Pentor; Institute for Opinion and Market Research, Warsaw; and various interviews with representatives from the Domestic Market Department of the Main Statistical Office. For 1989, socialized units include state-owned and cooperative units, as well as units owned by so-called "social organizations." For 1992, cooperative units have been reclassified as "private" by Polish statistics.

clined 82 percent, from 236,000 to 42,000, while the number of private units increased over 320 percent, from 300,000[4] to 970,000. The largest shift in the ownership structure occurred in the retail sector, where the number of private outlets increased by an extraordinary 996 percent, from 72,000 to 717,000. The number of privately owned retail stores, a subset of total retail outlets, increased by 1,267 percent, from 27,000 to 344,000 stores. Private catering businesses grew 347 percent, from 15,000 to 52,000, and socialized catering units declined 94 percent, from 16,000 to approximately 1,000. In the area of non-material services, where, even under the command economy, private outlets contributed over 43 percent of total turnover, the number of units actually declined by 6 percent, from 213,000 to 201,000. This decline is attributed to the general economic slowdown and lack of demand. The numerical changes in the sizes of the private and socialized sectors may appear somewhat more dramatic than the underlying reality, since a large number of cooperative and other "socialized" units have been simply reclassified as "private" (ca. 46,000 shops alone were "privatized" in this way). Even without counting the cooperative units, however, the growth of the private sector has been extremely impressive. The overall increase in the number of units has dramatically improved the access of Polish consumers to retail stores. Between 1989 and 1992 the total number of retail shops increased from 4 to 9 units per 1,000 people, and catering outlets increased from .8 to 1.4 units per 1,000 people.[5]

3.12. Changes in the ownership structure and the size of the domestic trade sector are also reflected in changes in the structure of employment. Total employment in the sector grew 6 percent, from 1.4 million to 1.5 million, between 1989 and 1991.[6] This increase may seem modest, but the official numbers probably understate the increase in real employment in the private sector, since private owners commonly under report the number of their employees (often family members) in order to evade the extremely high social security and wage taxes. Also, the increase in employment in the trade sector should be considered in light of the overall growth of unemployment, which reached 12 percent of the labor force during the same period. In addition to an overall increase in employment, there was a proportionately much larger increase in the number of self-employed, reflecting the shift away from state dominance toward private ownership. The number of self-employed and persons employing others increased fivefold, from 93,900 in 1989 to over 470,000 in 1991, and amounted to over 30 percent of total employment (up from only 6.5 percent in 1989).

3.13. While the present study is mostly concerned with privatization in the narrower sense of the term (i.e., a process by which formerly socialized units were replaced by private businesses operating on the same premises), the transformation of the domestic trade sector in Poland, especially in the early period of the reforms, was also driven by the emergence of new businesses, operating on premises previously occupied by other types of state-run businesses, as well as in makeshift locations, often on the streets or vacant lots. These new businesses, generally small kiosks and stands selling a limited and often changeable assortment of goods, account for over two-thirds of the growth in the number of units between 1989 and 1992. Despite their small size and often transitional existence, this increase in small private outlets played an important role in creating a genuinely competitive environment in which both the remaining state stores and the newly privatized units had to operate. The more dynamic new small businesses quickly filled temporary gaps in supply, and also forced other units to modify their behavior, with overall gains for the efficiency of the entire domestic trade sector.

3.14. The mainstream privatization process, involving the establishment of private businesses on the premises formerly occupied by socialized units, is the main object of the present study. The processes examined in the subsequent sections involve the privatization of approximately 69,000 retail stores and 76,000 smaller retail outlets, 15,000 catering units, and 34,000 service outlets — in total, approximately 82 percent of the former socialized sector trade network. Official data on the number of shops and other units privatized by the many *gminas* (municipal governments), state enterprises, and consumer and housing cooperatives are largely unavailable. But the researchers in the Privatization Project of the Central European University (referred to hereafter as the CEU Privatization Project), have pieced together estimates of units privatized by various governmental authorities, state enterprises, and cooperatives. The estimates are presented in Table 3.2.

B. Changes in the Real Estate Market in 1990

3.15. Prior to 1990, the use and disposition of commercial premises by both private and state

parties was strictly controlled by the Housing Act of 1974. Essentially, the Act gave the state a preemprive right to use any commercial property if a socialized (i.e., state or cooperative) enterprise needed the premises to conduct economic activities, or if the property was made part of a master plan for the allocation of retail or service outlets in a given area.[7] Rental arrangements with socialized enterprises were made on the basis of an administrative decision (with no negotiated, bilateral leases), and the property could be sold or leased only at prices set administratively by the Council of Ministers. This "special renting mode," as the system came to be called, meant that a committee of local officials decided on the "best" use of each available unit, and then chose an appropriate state enterprise or consumer cooperative to run the prescribed type of business.

3.16. Although the Housing Act did not formally apply to housing cooperatives, which owned a significant portion of commercial real estate, the cooperatives operated under essentially the same regime as a result of a provision in the Law on Cooperatives of 1982, which obliged them to follow the "social economic plan," as implemented by the local planning council. Similarly, while the system of administratively set prices did not formally apply to the housing cooperatives, they were not supposed to have been profit motivated and their pricing was based on an artificially calculated cost basis. In practice, the cooperative rents were usually lower than the administratively set rents for the premises that were owned by the municipalities.

3.17. The enforcement of the Housing Act and the related cooperative regime created strong disincentives for socialized enterprises to invest in their own premises, since the rents on premises they obtained from the state were set very low and lease terms were of indefinite duration.[8]

3.18. The 1990 Amendments to the Housing Act of 1974 gave real estate owners genuine rights to dispose of commercial premises and created new incentives for these owners to make better use of existing commercial space. A casual perusal of the

Table 3.2:
Poland: Estimates of Retail Stores and Catering and Service Outlets Privatized by Various Groups of Owners, 1992
(Thousands of Units)

	Retail Stores *(Excluding Smaller Outlets)*[1]	% of Total	Catering Outlets	% of Total	Service Outlets	% of Total	Total	% of Total
Gminas[2]	32	47	7-9	47-60	20	59	59-61	50-52
State-Owned Enterprises[2]	3-5	4-7	1-2	7-13	1-3	3-9	5-10	4-8
Consumer Cooperatives[2]	20-22	29-32	2-5	13-33	7-9	21-26	29-36	25-31
Housing Cooperatives[2]	12	17	1-2	7-13	4-5	12-15	17-19	14-16
Total	69	100	15	100	34	100	118	100

[1] Despite several attempts to compile information on the proportions of some 76,000 smaller non-shop retail outlets privatized by various entities, the size and the location of these outlets have prevented accurate estimates from being made. These outlets, which were often small stands or kiosks, were therefore omitted from this table.

[2] Data on gminas are based on reports from the Central Planning Office, interpolations using official data on changes in the number of socialized sector shops, a survey conducted by the CEU Privatization Project, and data from the Ministry of Privatization; data on state-owned enterprises are based on proportions revealed in surveys conducted by the CEU Privatization Project and data from the Department of Domestic Market at the Main Statistical Office; data on consumer cooperatives are based on information from the Main Statistical Office, proportions revealed in surveys conducted by the CEU Privatization Project, and interviews with various government officials and include only units actually conveyed to private hands and not units which continue to be operated by cooperatives (which have also been reclassified as "private"); data on housing cooperatives are based on interviews with officials from the Housing Cooperative Institute, proportions revealed in surveys conducted by the CEU Privatization Project, and data interpolations.

Source: CEU Privatization Project.

1990 Amendments would not have revealed anything out of the ordinary. The new provisions simply stated that commercial premises hitherto rented on the basis of administrative decisions were, effective immediately, to be governed by the appropriate provisions of the Civil Code. The "trick" was that the Civil Code gave the owner of the premises essentially unlimited freedom to terminate any lease of indefinite duration. The Amendments thus released municipalities and other parties from previous administrative controls, and conferred upon them a right to dispose, essentially at will, of the suddenly extremely valuable assets. The Amendments gave the existing tenants three months to renegotiate their rental agreements, after which the owners could evict them. The only right left to the old tenants was their ability to recover the expenses incurred for reconstruction, restoration, or modernization of the premises.

3.19. The immediate result of the Amendments was that real estate owners asserted their ownership rights in order to obtain an economic return on their assets. Where new leases were auctioned, rentals rose to exorbitant levels which inefficient state enterprises could no longer afford. When property was allocated by other criteria, state enterprises were not the favored party. The net result was a massive transfer of real estate use to private enterprises. One of the side effects of this "mass exit" was a disintegration of old retail empires which, deprived of a large proportion of their units, were commonly pushed into bankruptcy or liquidation.

3.20. Although housing cooperatives were not subject to the Housing Act and thus were not affected by the 1990 Amendments, a parallel process of reform also released them from the old structures and conferred on them genuine ownership rights to the commercial premises in their buildings. Formally, the housing cooperative leases had always had the form of bilateral agreements rather than of the "administrative leases" under the Housing Act, and the standard lease used by housing cooperatives allowed either party to terminate at any time, with only minimum notice. Under the command economy, housing cooperatives did not negotiate the length of the lease in advance. The demise of the old regime, however, brought about a change. The precipitating event was the 1990 Law Governing Cooperatives, which abolished the old cooperative associations that previously controlled the local cooperatives and also effected restructuring on the local level. Many local housing cooperatives split into smaller units, for example, and new authorities often took over. As a result of this new independence, the management of the local housing cooperatives became much more responsive to the needs of the cooperative residents (members). This series of events, more or less concurrent with the Housing Act Amendments, initiated a parallel wave of terminations of the leases between housing cooperatives and state enterprises or consumer cooperatives, with the resulting privatization of many shops, restaurants, and service outlets. In a matter of a few months, the large majority of commercial premises in Poland were allocated to new users, and the real estate market was changed beyond recognition.

C. Municipal Government (Gmina) Privatization

3.21. Perhaps the main beneficiaries of the restoration of genuine ownership rights in commercial real estate were the municipalities, which had owned a large portion of commercial premises, especially in urban areas. The following discussion covers the processes used by municipal governments (gminas) in Poland to privatize a large number of retail, service, and catering outlets that devolved on them through the 1990 Amendments to the Housing Act of 1974 and the new Law on Local Self-Government.

3.22. The Law on Local Self-Government, enacted on March 8, 1990, conferred on the gminas the ownership and control over all property under the control of the former basic territorial units of the central administration. The passage of the Housing Law Amendments coincided in time with a large-scale restructuring of municipal governments, which gained a large degree of independence from central authorities. One aspect of the devolution of authority effected through the law was a transfer to the newly created municipal governments of ownership rights to large amounts of commercial real estate, together with nearly complete autonomy to determine the purposes and uses of these properties. This transfer process, known as "communalization," became one of the major catalysts for the development of the private trade sector. This section is based on a series of interviews with local officials and an empirical survey of a random sample of 100 gminas conducted by the CEU Privatization Project in March 1993.

The Process of Gmina Privatization

3.23. There are 2,700 gminas in Poland. In the absence of a centrally imposed, uniform procedure,

"gmina privatization" has in fact been an amalgamation of 2,700 individual programs of ownership transformation. Indeed, the very idea of a "program" may overstate what took place: in 87 percent of the gminas examined in the CEU Privatization Project's survey, the process took place without a formal privatization plan approved by the elected bodies of the gminas.[9]

3.24. The municipal departments responsible for the disposition of communalized property began their work by preparing claims to the assets covered by the Law on Local Self-Government. In many cases, communalization was relatively straightforward, but the proportion of contested cases was also considerable, and uncertainty concerning title to a large number of units had a significant influence on the subsequent privatization process. The disputed cases could be brought before the appropriate voivoda, whose decisions could in turn be appealed to a special Property Devolution Commission, established by the Regulations Introducing the Law on Local Self-Government and appointed by the Prime Minister. Title disputes could also be brought before the courts. It appears, however, that many disputes are still unsettled.

3.25. The degree of involvement of elected municipal councils apparently varied widely among the gminas: the councils and the municipal boards (chief executive bodies of the gminas) sometimes remained entirely passive, sometimes approved the privatization of certain types of assets and determined the method of their transfer, and sometimes intervened ad hoc in particular cases. In most cases, however, the responsibility for implementing most of the privatization of communalized assets was delegated to a poorly staffed department of the local administration, or, in the case of rural gminas, where the number of units was relatively small, often to a single individual. This is not to say that higher officials in the gmina administration had no interest in the outcome of the process, but most of the interventions of the higher officials remained on an informal level, which gave them more flexibility to use the communalized assets to their best political advantage. The process also freed a tremendous amount of spontaneous initiative that was responsible for a remarkable transformation in the status quo of the consumer sector.

3.26. The parties most immediately and negatively affected were the state enterprises and consumer cooperatives. Consumer cooperatives and state enterprises lost the allegiance of their own members and employees, when the latter understood that, with communalization, they could become proprietors, if suitable arrangements could be made with the local authorities. These insiders were local people, with local ties and loyalties, and they argued that a transfer of their units to outsiders would drive up rents and lead to bankruptcies, social upheavals, and disruptions of supplies. Unions also constituted an important factor, defending the rights of insiders to continue operating their units, and sometimes backing their demands with the threat of strikes. Presumably, the insiders also used their informal connections with municipal authorities to defend their position.

3.27. The informality of the privatization process also offered the gmina officials unique opportunities for patronage and, in some cases, personal enrichment. In addition, local officials had a rather limited understanding of economic conditions, and were not inclined to disturb the existing order unduly: although they were willing to take premises away from distant state enterprises and consumer cooperatives, they were more sympathetic to the claims of the insiders employed in the local units. Finally, outsiders interested in acquiring newly communalized property were a relatively minor political force in the gminas: local entrepreneurs pushing for open, competitive allocation were a new and rather weak group, incapable of overcoming the standard popular resistance to radical changes that might exacerbate the growing problems of unemployment. A combination of these forces and factors was ultimately responsible for the predominance of insider-dominated arrangements, a host of restrictions on the changes that could be introduced in the wake of privatization, and the predominance of rentals over sales.

The Extent of Gmina Privatization

3.28. Even prior to the legal changes, local governments had controlled a large amount of real estate, and privatization had been moving forward. General statistics on the consumer sector in 1989 show that slightly under 28,000 shops (out of slightly more than 151,000), 15,000 restaurants (out of 31,000), and 214,000 service establishments (out of the total of 256,000) were already private at that time. However, the units of real estate involved in this early privatization were less desirable and were very small (on average, nearly one-fourth the size of socialized units). In terms of volume, the proportion of private retail trade to the socialized sector in 1989 was still barely 5 percent.

3.29. The process of privatization of the real estate reclaimed by the gminas through communalization involved the larger and more desirable units which in the past had constituted the core of the old socialized sector. In fact, out of the total of nearly 124,000 stores operated by state enterprises and cooperatives at the end of 1989, 31,662 were reclaimed by the municipalities and leased or sold to private individuals by 1992, when the process of gmina privatization was essentially completed, except for a handful of units, the titles to which were still in dispute. During the same time, 19,690 out of 41,500 state service outlets were privatized by the gminas. The process was also extremely swift: by the end of 1991, 24,762 shops had already been privatized, a figure that represents 40 percent of all shops lost to private persons by the state and cooperative sectors.

3.30. One of the most interesting aspects of gmina privatization is that at no point in the process did the municipalities have any rights to the businesses operated on the premises subject to communalization. The only rights acquired by the municipalities were the rights to the premises themselves, and the whole process, although leading to the privatization of the retail trade and services sector, *was in fact driven by a conveyance of the rights to real estate* that devolved on the gminas.

3.31. In effect, the gminas have not really privatized the real estate under their control, at least not in the sense of conveying full-fledged property rights in the premises to the owners of the businesses operating on these premises. Instead, in the great majority of cases (over 94 percent in 1990 and nearly 97 percent in 1991), the gminas leased the communalized premises, and the leaseholds conveyed to the new owners, according to the civil law in force in Poland, have the status of contracts rather than property rights valid against third parties.

3.32. Except for those cases in which the title to the communalized property is in dispute, the gminas' preference for leasing over sales (which tapered off only slightly in 1992) is not easy to explain. The officials justified their actions by a desire to maximize revenues. It is possible, of course, that the gminas feared that liquidity problems would keep private individuals from paying sufficiently high prices for the privatized municipal property, and that both rents and real estate prices would be moving upward in the future. This fear, if it was indeed a factor, was certainly unjustified, since the prices fetched by the few units that were sold were very high. A more rational economic explanation of the gminas' preference for rentals could be that the gminas did not want to divest themselves of their real estate holdings at a time of relatively high inflation (and with the absence of an opportunity to insure against it through other forms of investment). In addition, gmina officials may have perceived an outright sale as diminishing their influence in their communities, since their long-term control over real estate provided a powerful bargaining tool to use with a large number of potentially powerful outsiders.

3.33. The assets were usually not conveyed without additional limitations. Prohibitions on changes of the line of business were added often. Among other common restrictions were those prohibiting sublets or resales. These restrictions may have been particularly unfortunate, given the fact that most of the units were leased to previous insiders, who, (as is shown in the survey) were much less likely to invest in the business or otherwise restructure it. The reasons for these restrictions may have more to do with politics than economics: since the insiders were given preferential access to the privatized units, their ability to sell or sublet them would have provided hefty windfalls, which would, in turn, quickly delegitimize the whole system of insider preferences.

The Mode of Transfer

3.34. The central government, with its preference for openness and market procedures, was very much in favor of privatizing retail units through auctions. In fact, however, both our general survey (Chapter V) and the special gmina survey show that open auctions were used in Poland in only a small proportion of cases: in gmina privatization, the number was no greater than 27 percent. In addition to open auctions, the gminas also used auctions in which only insiders (employees) could participate, or in which insiders were given special preferences, usually a rebate (sometimes as large as 70 percent) off the first year rental (see Table 3.3). But the most common mode of transfer was a negotiated rental or sale in which the price was most often administratively determined, with insiders usually ending up as the main beneficiaries.

3.35. The choice of negotiated deals over auctions and competitive tenders resulted in marked, sometimes dramatic, losses of revenues from rents collected by the gminas, and also drove up the prices of real estate available through competitive procedures. In one district of Warsaw, administratively

set rents varied between Zl 5,000 and Zl 25,000 per m², while competitive pricing brought rents of up to Zl 1,560,000. In other areas the differences were less dramatic, but still enormous. In one sense, the low prices clearly reflected special terms offered to insiders, but evidence for a more economic justification of this practice is ambiguous.

3.36. Auctions conducted in the absence of a reliable market for similar units are apt to produce relatively high rates of overbidding errors. During the pre-reform period, a shop of any kind produced extraordinary returns owing to the simple phenomenon of shortage. Thus, at least in the early period of reforms, prospective buyers and tenants were apt to overestimate the value of the real estate for which they were bidding, especially in less desirable locations. This could in turn result in early business failure. Some evidences of such "overbidding," and the resulting business failures have been found.

3.37. In any case, the number of units which had to be reclaimed by the gminas as a result of nonpayment of rental fees was not very large: in the CEU survey of gminas it amounted to 5.8 percent of the privatized units. Although it is impossible to break down the failure figures by mode of transfer employed (auction or negotiated deals), there is substantial evidence that the greatest number of failures occurred among insiders, most of whom obtained their property through negotiated rentals. Also, while the expected failure rate (the number of times the gmina had to reclaim property) among gminas where negotiated rentals "typically" resulted in outsider-dominated establishments was 2.5 units, the same rate jumped to 5.4 units when the "typical" situation involved insider-dominated units.

3.38. An interesting feature related to the mode of transfer is the degree of security of tenure enjoyed by tenants and even owners of the premises "privatized" by the gminas. While results of the CEU study of gminas are incomplete on this point, they show that 50 percent of the gminas that acquired units through communalization had by March 1993 renegotiated transactions involving 15 percent of all privatized units. The conclusion to be drawn is that the usual term of the leases entered into by the gminas is very short: assuming that the average lease was entered into no longer than two years prior to the study, a significant percentage of leases must be for a period of less than two years. The short terms of these leases, especially when considered with the gminas' tendency to treat rented premises as still under their "control" (and to look to them as sources of higher revenues in the future), are likely to make tenants insecure and to have adverse effects on investment and restructuring.

3.39. As is evident, then, the primary beneficiaries of gmina privatization were the former employees of consumer cooperatives and state enterprises who managed to convert their status into ownership. While available information does not permit an estimation of the percentage of the communalized units that came under the control of their former employees, indirect data are in accord with the general belief in insiders' dominance. Outsiders were explicitly excluded from 2 percent of all transfers, and had to contend with auctions which included insider preferences in another 10 percent. The ability of outsiders to compete in direct negotiations, through which the largest proportion of units (61 percent) were transferred, is not known, but the outcome was heavily slanted toward insiders: in 74 percent of gminas in which direct negotiations were used, insiders were said to be the "typical" negotiating partners.

Table 3.3:
Poland: Methods of Transferring Commercial Premises by Gminas

Method of Transfer	Percentage of Units Privatized by Method
Direct Negotiation	61
Insider Auction	2
Auction with Preferences for Insiders	10
Open Auction	27

Source: CEU Gmina Study.

D. Privatization by Housing Cooperatives

The Role of Housing Cooperatives

3.40. After the municipalities, housing cooperatives had been the main real estate owners before 1989, and they played a correspondingly important role in the transfer of the use of commercial real estate into private hands, which constituted the essence of Polish small privatization . As we have seen, housing cooperatives had not been formally subject to the Housing Act of 1974, and thus the effective causes of the change in their rental policies were due not to the Housing Act Amendments of 1990 but rather to the dissolution of the cooperative associations and other changes related to the enactment of the 1990 Law Governing Changes in the Organization and Activities of Cooperatives. Also, the structure of incentives for the housing cooperative officials differed considerably from that for the representatives of the municipalities; consequently, the course of privatization controlled by the cooperatives was different from that of gmina privatization.

3.41. Unlike the municipal officials, who had to balance a greater variety of conflicting interests, the local housing cooperative officials, with their new degree of independence, could be more responsive to the needs of their members/residents. Housing cooperative officials thus most often pursued a rental policy dictated by the twofold interests of their membership. First and foremost, the members wanted to maximize revenues from the rental of commercial space so as to subsidize the residential tenants (especially in the wake of the withdrawal of state subsidies, which formerly covered over 30 percent of the costs). Second, they wanted to maintain certain types of stores in their housing complexes, especially when there were few other shopping areas in the vicinity.

3.42. Like gmina privatization, small privatization by housing cooperatives was an amalgamation of many unregulated and unmonitored processes. Consequently, housing cooperative privatizations were largely unrecorded. A very rough estimate of the number of units privatized by housing cooperatives is about 12,000.

The Type of Interest Conveyed and the Process of Allocation

3.43. Housing cooperatives, like gminas, overwhelmingly favored rentals over sales of their commercial properties, but their preference seems more justified, in light of their need to assure that certain types of services were provided to their tenants. The strong incentive of housing cooperatives to maximize rental income from their commercial properties was responsible for the fact that auctions were apparently used more often by the cooperatives than by the gminas, but no precise data are available on the proportion of units sold or leased in this way. There is also evidence that cooperative rentals were, on the average, significantly higher than those entered into by the municipalities. But direct negotiations also played an important role in the allocation of commercial premises by housing cooperatives, probably chiefly because of an interest in maintaining certain types of stores in cooperative housing complexes. Housing cooperatives were also less likely than gminas to impose burdensome restrictions on their tenants, but, to preserve certain types of services for residents, restrictions on changing the line of business between lease terms were relatively common.

E. Privatization of Units Owned by State Enterprises

3.44. The preceding sections have described the mortal blow given to most state enterprises by the 1990 Housing Act Amendments and the changes in the cooperative regime. In 1989, state enterprises in the trade sector ran approximately 36,000 retail outlets, of which 27,000 were stores. Of the 27,000 stores, approximately 15,000 to 17,000 were lost to communalization and housing cooperatives. But the loss of units did not lead to the immediate death of state retail trade enterprises. Some of these enterprises had constructed and owned stores in areas in which commercial space in housing cooperatives or government-owned buildings was unavailable, and a certain number of their stores were located on premises owned by the central government, which the state enterprises had been able to keep in the wake of the onslaught by the other real-estate owners. These enterprises were thus left with some 10,000 to 12,000 stores, and the reform of the old pseudo-cooperative system added some 2,300 new units to the state sector.[10] In addition, state enterprises were left with a large amount of warehousing space, their old distribution systems, and an extensive and costly central bureaucracy of the former large corporate structures, and the privatization of these assets is the subject of this section.

3.45. State enterprises managed to privatize some 3,000 to 5,000 stores throughout this period, not

an impressive figure, even considering the fact that the stores lost to communalization and housing cooperatives were the more attractive ones. However, since most state enterprises are in the process of liquidation, in the course of which often an entire business is privatized in one fell swoop, a large number of the remaining units may be transferred to private hands in the near future.

3.46. Privatization of state enterprises in the retail trade sector has occurred primarily through the so-called "liquidation" method, and, after that, through the leasing of individual units to third parties (often employees) by particular enterprises. In a few cases, for example those of large department stores or specialty shop chains, state enterprises were expected to be converted into joint-stock companies, and privatization would be scheduled to follow through a sale of shares to foreign or domestic investors.[11] Very little information is available on these "capital privatizations" (as they are known in Poland), but apparently, with the exception of a small number of partial acquisitions or joint ventures, not much has taken place as yet. More information has been obtained about the process of liquidation.

3.47. "Liquidation" is a term that refers to two separate processes under Polish law. First, enterprises that are insolvent may be liquidated under Article 19 of the 1981 Law on State Enterprises, which specifies a bankruptcy procedure for state firms. With these liquidations, the assets of the bankrupt company are either sold or contributed by the state to a successor company, such as a joint venture or a similar arrangement. The most important fact about the insolvency liquidations is that they do not require the consent of the employee councils, which are a powerful force in many Polish state enterprises, and thus fewer concessions to the insiders are necessary. In practice, however, even though the sale of assets is supposed to be public, the assets are most often acquired by the enterprise insiders, who receive preferential terms and subsidized loans.

3.48. In addition to insolvency liquidations, state enterprises may be subject to another form of liquidation, governed by Article 37 of the 1990 Law on Privatization of State-Owned Enterprises. To qualify for this process, enterprises must be solvent, and the "liquidation" is in fact a form of privatization, in which the assets of the enterprise are sold or leased to a new company, formed especially for this purpose by the employees, often with the participation of outside investors. In addition to requiring the consent of the employee council, Article 37 liquidations also permit a leasing of the enterprise assets (and not just their sale), which makes the whole process much more attractive to the employees.[12] A liquidation plan under Article 37 is worked out between the enterprise and the founding organ (usually, in the case of trade enterprises, the local voivoda or the mayor of a large city), with the Ministry of Privatization having only a supervisory function. It is perhaps a measure of the spontaneity of the Polish small privatization that this most decentralized form of formal privatization under Polish law is the most bureaucratic and cumbersome method of privatizing retail stores and catering and service establishments.

3.49. Prior to liquidation, the central state enterprise or association would be dissolved and the responsibility for the regional branches would devolve on local officials, who would assume the role of founder.[13] The actual process of liquidation would be as follows: the founders would install a new director (or a liquidator in case of insolvency) whose main task would be to restructure the enterprise and prepare it for privatization. The voivoda would supervise the process and assist in the privatization through training and other means. Prior to preparing a privatization plan, two essential problems would need to be addressed. First, many of the stores that were lost through the communalization process and to housing cooperatives had inventories of goods and equipment that had been appropriated by employees. Pursuing and resolving these claims would be an important function. Second, the high level of overstaffing would need to be reduced.

3.50. Finally, a privatization program would be prepared. A portion of the assets would usually be sold off to outsiders in order to improve liquidity and pay off the debts of the enterprise, while the remainder would be scheduled for an employee buyout or a leasing program. In some cases, all or most of the units would be kept together and the enterprise assets would be sold or leased as a whole to a successor employee-owned company. In other cases, individual shops would be privatized individually (usually sold or leased to the employees), with only a few assets remaining to be liquidated. The law requires that all sales of assets of liquidated enterprises be public but the property need not go to the highest bidder, and other criteria (including insider status) may be decisive. As a result, public participation is often minimal or nonexistent, and, in most cases in which sales actually took place, they

resulted from negotiations with the employees. The assets to be sold must usually be evaluated by a local consulting firm or the liquidator himself, but in the cases studied for this report, the actual sale price was no more than one-third of the original valuation.

F. Restructuring and Privatization of the Polish Consumer Cooperatives

3.51. Prior to 1989, consumer cooperatives were the largest owners and operators of retail and catering establishments in Poland. Cooperatives ran approximately 96,000 stores (64 percent of the total and 77 percent of the socialized sector) and 44,000 other outlets. In addition, they operated over 13,000 thousand restaurants and other catering establishments (42 percent of the total and 81 percent of the socialized sector), and they accounted for 13 percent of the sales of services.

The Liquidation of Cooperative Associations

3.52. Under the old regime, cooperatives were organized in a hierarchical series of associations. All local consumer cooperatives of a particular organization (including two giants in the retail sector, Spolem, and Samopomoc Chlopska, as well as smaller specialized organizations) were grouped together in regional associations, which were in turn linked with other regional associations in nationwide unions. The upstream organizations were organs of the command system of distribution. They had control over purchasing centers, wholesale units, and transportation networks. They held financial assets, maintained relationships with the banking system, received obligatory payments to their "development funds" from local cooperatives, and decided upon the distribution of monies from that fund. The local cooperatives had no choice of suppliers and no control over their own expansion, and the overwhelming proportion of their revenues was siphoned off by the upstream organizations (disbursements to members were usually in the neighborhood of 3 percent of the profits). Not uncommonly, local cooperatives had been forced to transfer to the association a portion of their own assets, such as a plant or another enterprise, that the association was interested in operating directly.

3.53. The cooperative, or rather pseudo-cooperative, system (since the cooperatives were tightly controlled by central organizations dominated by the state) was thus clearly a fundamental impediment to the creation of an efficient consumer sector. The first post-communist government undertook to reform the cooperatives and destroy their monolithic organization. The outcome of this effort was the January 1990 Law Governing Changes in the Organization and Activities of Cooperatives (the "Cooperative Restructuring Law"), which dissolved the central cooperative bodies and other cooperative associations, and mandated a transfer of their assets to new owners. Paradoxically, however, the Cooperative Restructuring Law was never followed by the planned more comprehensive reform of the cooperative movement, so that local cooperatives in Poland, unlike their Czech and Hungarian counterparts, are still governed by outdated communist legislation, dating back to 1982.

3.54. The restructuring and privatization of the consumer cooperative movement in Poland involved four different processes. First, the Cooperative Restructuring Law attacked the cooperative associations directly, privatized a significant portion of their property (which did not include many retail units, but had a very significant impact on the wholesale and distribution systems), and released individual cooperatives from centralized control. Second, the cooperative system lost units as a result of the 1990 Housing Act Amendments and the restructuring of housing cooperatives, with effects similar to those for state enterprises. Third, local cooperatives, cut from the tutelage of the associations and the subsidies channeled through them by the state, and weakened by the loss of units through communalization and other claims to the premises on which many of their best units had been operating, started selling or leasing their stores and restaurants to private parties, most often to their own members and employees, but sometimes also to small outside entrepreneurs. Fourth, local cooperatives themselves were privatized, in part through a stroke of a bureaucrat's pen, since they were reclassified as "private" and ceased to be considered a part of the "socialized" sector, but in part also because they ceased to be state controlled and, at least to some extent, restructured their operations.

3.55. The Cooperative Restructuring Law placed all cooperative associations into immediate receivership, to be followed by liquidation proceedings. The liquidators were responsible for developing plans for the disposition of all assets of the associations, and managing them in the transitional period. A liquidation plan would then be presented for the approval of the representatives of the local

cooperative members of the association, with the Ministry of Finance and its representatives reserving the right to approve it if the membership failed to act within a 30-day period.

3.56. The first point of a liquidation plan was to exclude from the assets of the association any plants or other assets which had been transferred to the association without payment from local cooperatives during the preceding ten years. All assets of this kind were to be returned to their original owners. Financial assets of the association, such as working capital and reserves held in development funds, were to be used to repay the liabilities of the association and defray the costs of the liquidation. With respect to the remaining assets, the Cooperative Restructuring Law provided for the following methods of disposition.

- Assets could be transferred to member cooperatives, with or without payment. Usually, no payment would be required if a local cooperative took over a business previously run by the association together with its liabilities. If the association paid the liabilities associated with the transferred business, the receiving cooperative would be required to make a partial or total payment.
- Another group of preferential recipients were the employees of the business associated with the transferred asset. For this purpose, at least half of the employees had to found their own cooperative and capitalize it at an appropriate level (at least three months ' salary from each member), and the asset might then be transferred to them without payment.
- Assets not transferred to local member cooperatives or the employees could be sold at auctions open to the public.
- Subsequent amendments to the law allowed for assets to be transferred to joint-stock or limited-liability companies established by former workers or cooperative members.

3.57. The mechanics of the Cooperative Law ensured that the distribution of assets would be determined primarily by negotiations among the liquidators, employees, and local cooperative officials. Outside investors seem to have played a minor role, but they may have been involved behind the scenes in a number of cases. Despite the law's unambiguous mandate, few assets were sold through truly open auctions. (Apparently, despite their dubious legality, closed auctions, by invitation of the liquidator, were rather common.)

3.58. The Cooperative Restructuring Law also created a new cooperative association, the Supreme Council of Cooperatives, to serve as the domestic and international representative of the sector, but membership in the Council is purely voluntary. The remaining cooperatives are also allowed to form other types of voluntary associations, and it is perhaps a measure of their difficulty in "going it alone" that the growth of such organizations has been very rapid. Thus, for example, shortly after the beginning of the liquidation process, some 200 local cooperatives from Samopomoc Chlopska formed an "economic chamber." As of the end of 1992, membership in the chamber had grown to 1,670 cooperatives.

Privatization of and by Local Cooperatives

3.59. The abolition of cooperative associations had two significant consequences for the Polish trade and service sector. First, the sale of the property of the associations created a decentralized pattern of ownership over warehouses and other means of storage and product distribution. The resulting diversity of potential supply sources was essential to the genesis of competition and market behavior. Second, and perhaps more important, the breakup of the associations changed the cooperative sector from one characterized by hyper-centralization into one in which individual cooperatives were forced to fend for themselves. Placed in the unfamiliar position of having to manage their own financial resources and make their own business decisions, cut off from their previous sources of ready credit and subsidization, individual cooperatives often found themselves forced to sell or lease their units in order to maintain even a semblance of stability. As a result, a large number of retails stores, restaurants, and service units were transferred to private hands, and the remaining cooperatives themselves were often transformed into more independent, business-oriented organizations.

3.60. The Cooperative Restructuring Law required that cooperatives hold new elections within less than three months from the passage of the law or face liquidation. Because of the short time span, however, new forces were unable to organize, and, only an estimated 15 percent of elected officials were new entrants, with the rest representing the old cooperative *nomenklatura*. The Cooperative Restructuring Law also provided that each discrete organizational unit of an existing cooperative, or a

unit that might become organizationally independent, had a right, to separate from the rest of the organization. But there appeared to have been little interest, and only 100 new consumer cooperatives were created within the first two years of the enactment of the law.[14]

3.61. The only other legal change in the structure of the Polish cooperatives was brought about by the 1991 Law on Valorization of Members' Shares in Cooperatives, which allowed cooperatives to increase the value of each individual member's share, at the expense of the financial assets held in the indivisible common fund. While this change made the concept of cooperative membership somewhat more meaningful than before, the law also imposed a five-year restriction on cooperative asset alienation, which made exit more difficult and decreased the likelihood that cooperatives would be dissolved or transformed into other types of business entities.

3.62. Again, privatization by local cooperatives, like most forms of small privatization in Poland, has been an extremely decentralized and diversified phenomenon, and it is difficult to come up with reliable numbers concerning its results. On the basis of deductive calculation, it is estimated that through the end of 1992 the number of stores operated by consumer cooperatives had declined by approximately 51,000 units subject to some form of privatization. Of these, approximately 27,000 to 29,000, or 53 to 57 percent, were lost to communalization and housing cooperatives through the mechanisms described earlier. We are thus left with a balance of 20,000 to 22,000 shops, which represents a fair estimate of the number of units privatized by consumer cooperatives themselves.

3.63. Unhampered by any legal regulations, cooperatives were free to privatize their units in any manner they selected, and to attach any number of conditions to their subsequent operation. In general, cooperatives have favored leases over sales, and have offered the first choice of rental to the employees of the privatized unit. The reasons why consumer cooperatives favor leasing over sales (and the rentals are usually of fairly short duration)[15] appear not to be related to revenue maximization and may be linked to a belief in the future development of the cooperative retail sector. Interviews with cooperative managers indicate a certain assurance among them that the financial conditions of cooperatives will improve. Retention of ownership control over property may thus be viewed as an important factor for future growth and diversification. On the basis of the limited available data, it appears that leases regularly contain restrictive provisions, mostly concerning changes in the line of business. These are more common in rural areas, where such restrictions may make sense (but may also be the result of less competition among owners of real estate). There was also a detectable desire on the part of a number of cooperatives to ensure that lessors do not compete with the stores retained by the cooperative or leased to other individuals. Protection of cooperative supply systems may also have played a role.

3.64. The unwillingness of cooperatives to cede ownership or true operational control over their units, taken together with their attempts to recreate nationwide networks of cooperative associations, could indicate that the transfer of previously cooperative units to genuinely private hands may be a reversible phenomenon. It remains to be seen whether the cooperatives will reestablish themselves as a united force in the domestic trade sector, and what effect their new organization will have on the state of the competition in the retail market.

Notes

1. The government's liberal stance on foreign trade was a major factor in the growth and expanded assortment of consumer goods. Between 1989 and 1992, consumer imports, as a percent of total imports, grew from 12 to over 34 percent.
2. Voivodships are the largest territorial units of the Polish government. There are 49 voivodships, each headed by a prefect, or voivoda.
3. This result is confirmed by the Survey in Chapter V.
4. The apparently very high number of private units in 1989 tends to exaggerate the private sector's share of trade at that time. Most private units were small stands, booths, and service workshops set up within months of the enactment of the Law on Economic Activity on January 1, 1989.
5. *GUS Statistical Yearbooks* 1989-92, Institute of Internal Market.
6. *GUS Statistical Yearbook.*
7. The restrictions did not apply to privately built shops and workshops if they were used according to their designated purpose by the owner or his family, or to buildings owned by socialized enterprises.
8. Once it had been assigned, the use of the premises was rarely changed.
9. A fairly large number of gminas in our study (34) did not obtain any units through communalization. If these are left out, the percentage of gminas without a plan falls to 81 percent.
10. The reform of the cooperative network of over 20,000 kiosks and some 2,300 stores, selling newspapers, cigarettes, and a variety of other goods, led to the establish-

ment of a new state-owned joint-stock company, "Ruch," which became a part of the state sector.

11. The largest joint-stock company of this type is the "Ruch" chain, with a near monopoly on the distribution and sale of newspapers, periodicals, cigarettes, and a number of convenience items.
12. The leasing involved is actually a form of installment sale, with the title passing at the end of the lease term. The terms are also advantageous because the interest rate on the sale is in practice negative.
13. The founder organ, under the Law on State Enterprises, has a multitude of rights and responsibilities concerning the running of a state enterprise. As the formal representative of the state, it also plays an important role in enterprise privatization.
14. Separation was more common among housing cooperatives, which served much better defined constituencies.
15. Case studies commissioned by the Privatization Project showed that leases with determinate time periods ranged from one to three years. Cooperatives also showed a propensity to conclude leases of indeterminate length which, under laws operative in Poland, allows for a termination of the lease by either party with 30 days' notice. Such behavior may prove to create significant disincentives for leaseholders to invest in their business.

Chapter Four

Hungary

A. Introduction

4.1. The Hungarian approach to the privatization of the trade and service sector has differed considerably from the approaches adopted in Poland and the Czech Republic. While the latter two countries attempted above all to remove the state as rapidly as possible from the running of their shops and restaurants, the primary objectives of the Hungarian authorities were far more complex. In addition to the goal of de-statization, Hungary's approach might be characterized as focusing on three important objectives: (1) to create a market structure similar to that in Western economies; (2) to raise revenues to finance the state budget deficit; and (3) to assert effective governmental control over the process of privatization itself.

4.2. To these ends, Hungarian officials have made use of a number of privatization strategies, and the privatization of individual shops, as opposed to large state trade organizations, has been considered appropriate only for a portion of the sector. The majority of state assets in trade and services have been, or are about to be, privatized in ways that emphasize the transfer of many units together, grouped to form integrated commercial entities. "Small privatization," as this term is normally used, is thus in no way synonymous in the Hungarian context with the privatization of the entire trade and service sector.

4.3. Why have the Hungarian officials elected to pursue privatization strategies so markedly different from those of neighboring Poland and the Czech Republic? The Hungarian policies can be better understood if the events following the demise of the communist regime are placed in a broad historical context. In essence, the situation in Hungary differed from that in Poland and the Czech Republic because of Hungary's legacy of years of reforms that had preceded the change of regime. The Hungarian retail and service sector, in particular, had experienced a series of reforms dating back to the late 1960s, when the so-called New Economic Mechanism (NEM) changed the relations between enterprise managers and government officials, as well as between enterprise managers and the managers of individual stores and restaurants.

4.4. Under the NEM, the locus of most economic decision-making shifted from the ministries to individual enterprise managers. Enterprise managers were gradually given control over such decisions as the line of business of individual stores, their supply arrangements, the internal organization of enterprises, and ultimately the pricing of the goods sold in state shops. The devolution of real authority onto enterprise management culminated, in 1988, with the "Company Law"[1] which allowed managers to divide their enterprises and spin off diverse subsidiaries without obtaining ministerial approval. Trade enterprise managers then attempted to create new commercial companies, which were removed from state oversight. Exploiting lax controls over the movement of state property, some of these managers, through a process known as "spontaneous privatization," transferred prime state assets to themselves or to their foreign and domestic business partners. These improvisational privatizations in the trade sector incited some of the largest scandals of the last years of the communist regime.

4.5. Other reforms, begun in 1968, affected the relations between enterprises and managers of individual state stores. At first, profit incentives were introduced into the pay packages of shop managers. These profit-sharing arrangements were then gradually expanded during the next two decades, as many shops were leased to the employees and other parties and as shop managers acquired increasing autonomy in running their units. As a result, a growing number of decisions concerning the operation of the sector were made not in accordance with the dictates of remote planners, but by store and enterprise managers on the basis of profitability and consumer demand.

4.6. Consumer cooperatives, the other half of the socialized trade sector, were also affected by the general movement away from centralized control. Between 1969 and 1971, a series of laws freed consumer cooperatives from many restrictions that had previously prevented them from operating stores in urban areas and had interfered with their business decisions. The role of the National Federation of Cooperatives in running the daily operations of cooperative stores was reduced and, as in the state sector, profit-sharing and other contractual arrangements became common.

4.7. Perhaps most important, the reforms of the last two decades of the communist regime ended the socialized sector's monopoly in trade and catering. Although private entrepreneurs were restricted by various limitations on the size of their businesses, access to foreign markets, and the opportunity to limit personal liability for losses, the state permitted and even encouraged a variety of private economic entities. Legislation concerning private economic activity became increasingly liberal and resulted in the very rapid growth of the new private sector. By the late 1980s, all segments of Hungarian retail trade and services included a sizable private component. The state still retained its monopoly on wholesale trade, severely restricting the range of products offered to consumers. Regional enterprises still operated extensive networks of shops and dominated the market in urban areas, while rural trade was the all but exclusive domain of large consumer cooperatives. The maze of regulations and restrictions was responsible for an unusual ownership and control structure of the sector, with state enterprises being able to derive substantial profits through subleasing their state stores to private parties. But combined with macroeconomic changes, such as price liberalization and the growth of foreign trade, the new system introduced a measure of competition and efficiency into the provision of consumer goods and services unknown in the other countries included in this study. Hungary's early reforms bequeathed to the democratic government elected in 1990 a trade sector that bore scant resemblance to those in Poland and Czechoslovakia.

4.8. It was the superior performance of the Hungarian trade sector that accounts for the very different Hungarian approach to privatization after the end of the old regime. To begin with, in Hungary the importance of the immediate privatization of most shops and restaurants was less evident than in, for example, Poland, since the population was fairly well served by the existing system. In addition, in Hungary, privatization under the old regime had been regarded with some distrust owing to its "spontaneous" version, and calls to curtail its abuses initially drowned out the demand (so strong in Czechoslovakia and Poland) for further ownership reforms.

4.9. The government's need for money to service Hungary's large foreign debt increased its incentive to exert control over privatization. Since the trade sector was identified as a particularly attractive area for foreign investment, halting its spontaneous privatization was of special interest to the new government.

4.10. While the reassertion of control over state property slowed the progress of privatization, the desire to assure that the proceeds from privatization would be available for the state budget served as an incentive for the formation of a privatization plan. The need to act quickly, at least with respect to the trade sector, was also underscored by the numerous calls, heard during the first post-communist election campaign, for the restitution of private property nationalized during the old regime. The fear that restitution might interfere with the government's objective of raising revenues from privatization gave added priority to setting a privatization strategy for the trade sector.

4.11. The opposition of the sectoral insiders to a centralized privatization strategy and the state's desire to circumvent this opposition without a major confrontation provide the principal explanation for the further course of events.

4.12. In September 1990, the government announced its "Preprivatization" Program, which was designed both to assert governmental control over the privatization process and to spawn a stream of revenues for the state. Preprivatization was a centralized program to be run by the newly estab-

lished State Property Agency (SPA), aimed at selling, at public auctions, the state's rights to a part of its shops, restaurants, and service outlets. But Preprivatization was also designed to avoid excessive confrontation with the managers of the sectoral state enterprises, and for this reason the program did not apply to all state assets in the sector. Instead, the primary targets were those shops and restaurants that had been leased to private entrepreneurs and were thus the least integrated into the functioning of state enterprises. In all, the program applied to no more than 30 percent of the state establishments (between 10,000 and 15,000 units).

4.13. SPA strategies for dealing with the portion of the commercial sector not affected by Preprivatization were slow to develop and slower to be implemented. The programs that followed included the First Privatization Program and Self-Privatization, both of which had a broader scope and included a range of enterprises outside the trade and service sector. Both of these programs have encountered problems and succeeded in privatizing only a small number of enterprises. In addition to these major efforts, the SPA has either announced, or is in the process of preparing, other, more limited privatization schemes designed specifically for certain portions of the commercial sector, such as pharmacies, or new chains carved out of units presently belonging to various state enterprises. The government has had only limited involvement in the changes that have altered the role of the consumer cooperatives, a process that has occurred with only minimal property transfers.

The Role of the SPA

4.14. Despite the large number of privatization programs in Hungary, a consistent and persisting strategy of the SPA can be discerned. In every program since Preprivatization, the SPA has been active in selecting the enterprises and units to be included and has been involved in the elaboration of detailed privatization and post-privatization plans for the new firms. While the SPA's role was most visible in the First Privatization Program, its influence in Self-Privatization has also been pervasive. The SPA has retained control over entry into the program and all essential decisions along the way. Plans for the privatization of new chains in the retail sector are similarly based on the SPA's choice of the sub-sectors and enterprises involved, as well as of the detailed mechanics of the process.

4.15. In all of its programs after Preprivatization, the SPA has focused on the privatization of entire enterprises rather than individual shops and restaurants. This move away from the usual model of small privatization has been predicated on the desire to shape the post-privatization trade sector in Hungary in the image of the commercial sector in the West, with its emphasis on companies that integrate wholesale activities with large chains of retail or service outlets. This approach, called "insider" or "technocratic" in our earlier discussion of Czech privatization, gained much greater acceptance in Hungary than in the Czech Republic or Poland.

4.16. In the Czech Republic, as has been pointed out earlier, the proposals for keeping the organizational structure of state enterprises intact were defeated by the public hostility to sectoral insiders, the enactment of restitution legislation, and the ideological opposition of the Ministry of Privatization. In Poland, the technocratic approach to privatization of the trade sector was decisively rejected from the very beginning: since the endemic shortages of most goods were taken as proof of the bankruptcy of the old system, the idea of preserving the structure of the state enterprises had no appeal. In Hungary, in contrast, reforms under the old system, while far from perfect, did provide a substantial improvement in the availability of consumer goods and services, and thus the managers in state trade enterprises could claim a measure of social approval. The hostility to sectoral insiders was also lessened in Hungary by the more pragmatic nature of the old regime. Finally, the financial needs of the state further spurred the adoption of a technocratic strategy, since government officials assumed that sales of trade enterprises with large networks of shops would be more lucrative and, unlike individual stores, would attract foreign investors.

4.17. There may also have been a degree of conviction that Western models were more appropriate for Hungary than was the anti-statist approach of the Czech Republic or Poland. A large proportion of the SPA staff was in fact drawn from the former branch ministries and selected for its expertise in restructuring state enterprises. These officials were perhaps predisposed to support technocratic privatization strategies that called for their particular skills.

4.18. The accomplishments of these technocratic programs have been disappointing. The failures of

the First Privatization Program pointed up the weaknesses of "over-engineered" solutions. The Self- Privatization program has been more successful in privatizing a number of small service firms, but has not achieved notable success with respect to larger trade enterprises. The SPA's efforts to privatize the remaining parts of the state sector have also been stalled by debates over which technocratic model to follow.

4.19. The SPA's difficulty in devising smoothly functioning privatization mechanisms has given rise to a peculiar internal dynamic common to many Hungarian privatization programs. Faced with the clogged central mechanisms for privatization, enterprise insiders, as well as outside investors eager to purchase the remaining state units, have attempted to find alternative avenues of ownership transformation. This pressure has led to a situation in which each program has ended up with its own unintended privatization mechanisms, many of which allow the interested parties to detach individual units from their enterprises. It appears likely, for example, that fewer than one-half of the units ultimately privatized under Self-Privatization will be privatized as part of an entire enterprise, and that ways have been found to circumvent the competitive procedures designated as "exclusive" in the program. The majority of units appear destined to be transferred individually, through liquidation sales or other unpredicted transfer procedures. While, on the surface, therefore, Hungarian privatization programs have followed the technocratic models, their actual outcomes have often differed significantly from what was planned, and fewer enterprises than expected have been sold as a whole.

Quantitative Evidence of the Transformation

4.20. Between 1988 and 1992 the total number of active establishments in the Hungarian trade sector nearly doubled (Table 4.1). This growth has been spearheaded by an almost 300 percent increase in the number of private units, which comprise new entrants and privatized state and cooperative units.

4.21. The extent of privatization can only be approximated. Of the 12,000 units that disappeared from the state sector between 1988 and 1992, it is estimated that the majority (about 10,000) have been privatized. The remainder simply changed their organizational form: instead of being parts of state enterprises, these units became incorporated in new and still largely state-owned joint stock companies.[2]

4.22. While the rate of small privatization has been slower in Hungary than in Poland and the Czech Republic, the growth of the new private sector has been very impressive. By the end of 1992, units operated by private dealers and incorporated companies (many of which are private) accounted

Table 4.1:
Hungary: Change in Affiliation of Units in the Retail and Catering Sector from 1988 to 1992[1]

	1988	1990	1992
State Enterprises	26,366	17,410	14,000
Incorporated Companies[2]	671	6,240	30,000
Cooperatives	27,349	22,323	18,000
Private Dealers	34,541	60,141	102,755
Total	**88,927**	**106,114**	**164,755**

[1] There is some disagreement concerning the number of private shops and catering establishments at the end of 1992, with estimates ranging as high as 200,000.

[2] Incorporated companies include limited partnerships, limited liability companies, and joint stock companies.

Sources: *Hungarian Statistical Yearbook* and Erzsébet Gem, "Private Enterprises in Retail Trade," unpublished manuscript, 1993; Central Statistical Office, unpublished data.

for almost 80 percent of the Hungarian stores and restaurants. While their share of the turnover is less impressive than the number of units, the official turnover figures (50 percent) almost certainly underestimate the new private sector's share of the market (which may be as high as 70 percent).

4.23. However, the stores originally controlled by the state were, by and large, among the most productive units, situated in the most desirable locations. Ownership control over these stores is thus at the heart of the ultimate transformation of the Hungarian consumer sector, and for this reason the unfinished nature of Hungarian small privatization remains important.

B. Pre-1990 Reforms

History

4.24. Hungarian economic reforms prior to 1990 introduced important structural and functional changes in the trade and service sector. Deregulation, distribution of decision-making authority among sectoral participants, and the encouragement of small establishments were the hallmarks of these policy changes. It is useful to divide these reforms into two periods: (1) those undertaken prior to 1988; and (2) those initiated between 1988 and 1990. Free elections in 1990 announced the end of this first period of Hungarian trade transformation.

4.25. Despite our focus on property reforms, price setting reforms and the structure of foreign and wholesale trade were also of great importance in the evolution of the Hungarian trade sector. Experiments in freeing prices began in the 1960s. By 1988, between 60 and 70 percent of retail prices were freely set and price adjustments were often linked to the convertible currency prices for goods traded on foreign markets. Reliance on market mechanisms decreased arbitrage opportunities for private individuals seeking to exploit the difference between official and black market prices, probably discouraging the most blatant forms of parasitic private economic activity. At the same time, legitimate private enterprise was encouraged by the freedom to price goods according to market responses. However, while price liberalization encouraged the creation of private commercial establishments, the unwillingness of governmental authorities to allow private entrepreneurs into wholesale and foreign trade affected the development of private trade establishments. The state relaxed its monopoly on foreign trade only in January 1990.

Pre-1988 Reforms

4.26. Within the firms classified as belonging to the state sector, there existed, prior to 1988, a variety of arrangements with varying degrees of market incentives and private participation. These reforms had, by the end of the 1980s, already altered the operation of the sector. Two distinct categories mark these reforms: the reform of state enterprises, and the creation of private business opportunities.

Reform of State Enterprises

4.27. Until 1968, state enterprises were centrally controlled by branch ministries. The Ministry of Domestic Trade (reorganized as the Ministry of Industry and Trade in 1990) oversaw the activity of state enterprises organized by product line and by region. In each of the country's regions, one state enterprise held a monopoly concerning a particular line of activity. Each enterprise supervised a number of retail units, setting targets for sales and wages and allocation of inputs. Wholesale supply was organized along a parallel structure, with enterprises purchasing supplies from designated regional suppliers. Inter-regional or ad hoc supply relationships were forbidden.

4.28. A degree of flexibility was introduced in 1968 with the NEM program. Fundamental regional organization structures were left unchanged, but decision-making authority was shifted over time from branch ministries to the enterprise level. Obligatory input and output quotas were abolished in 1968, and scope for genuine profit-and-loss calculations in state enterprises was expanded. Wholesale enterprises were permitted to engage in cross-regional trading, and retail trade enterprises could buy directly from producing enterprises.

4.29. Further reforms in 1977 and 1984 gave considerable autonomy to enterprises by establishing "Enterprise Councils," a majority of whose members were elected by workers and employees. The responsibilities of the Councils included election of the enterprise director, determination of changes in the line of the firm's activity, and organizational changes in the enterprise. Direct state oversight of enterprise activities was retained in only roughly one-third of the enterprises which were classified as of strategic importance. State managers were given a wider degree of freedom to operate and restructure their self-managed enterprises. Devolution of authority and the decentrali-

zation of decision-making in the economy resulted in a far-reaching separation of the ownership of state assets from their day-to-day control.

4.30. Reforms in the state sector extended not only to enterprises but also to individual units, such as stores or service outlets. Changes at the level of individual units resulted in the following three arrangements. *Independent accounting arrangements* created performance-based compensation for individual commercial units, which maintained their own accounts and were allowed to retain some portion of the unit's residual profits. *Contractual arrangements* called for greater unit independence. Managers gained the right to make product line, supply, and pricing decisions. In return, they paid a set fee to the parent enterprise, and had an agreement to purchase certain goods from the parent. *Rental agreements* removed the contractual supply conditions on managers. Essentially, they were indistinguishable from familiar subleases.[3] Contract and rental unit workers retained the status of state employees, but by the mid-1980s, managers had acquired the right to hire and fire workers. Rental and contractual agreements were, however, limited to units of relatively small size.

4.31. Contractual and rental shops, while numerous, were usually small, relatively under-performing establishments. Thus, their share of total employment in the sector was nearly twice as large as their share of turnover, and per unit employment was less than half of the overall 1988 average in state enterprise units. Still, these arrangements were credited with improving the performance of the least profitable portion of the state trade sector and injecting some market elements into retail and catering enterprises. Contractual and rental arrangements, however, had a somewhat perverse impact on the role of state enterprises in the provision of consumer goods and services. Allocating rental and contractual rights, in fact, became an animating factor in the economic activity of many state enterprises; it has been estimated that some state enterprises received 40 to 50 percent of their revenues from contractual and rental payments.[4]

The Creation of Private Businesses

4.32. The liberation of private initiative, independent of the developments affecting state enterprises and cooperatives in the trade and service sector, began in the late 1970s with legislation allowing for the creation of Civil Law partnerships and the enactment of the Law on Domestic Trade. These regulations provided a legal framework for operating private businesses and opened the commercial sector to private initiative. Private activity was constrained, however, by the need to obtain official approval prior to operating a business and also by strict size limitations. Additional legislation in the early 1980s increased the array of accepted legal forms of business organization. By the mid-1980s, private business activity in the trade sector could take a myriad of forms: artisan, private retail trader, private caterer, small cooperative, and a form roughly analogous to general partnerships.[5] The steady increase in the number of private traders did not, however, translate into a corresponding growth in the volume of sales; although private retail and catering establishments comprised close to 40 percent of the total units in the sector in 1988, they controlled only slightly more than 10 percent of the market.

Transformation from 1988 to 1990

4.33. In the period 1988-90, a reform strategy was adopted that created incentives for state enterprise insiders to change and restructure their institutions on their own. Three legal regulations, the Company Law, the Foreign Investment Law, and the Transformation Law, gave enterprises the freedom to sub-divide into smaller entities organized as commercial companies, such as limited liability and joint stock companies.

4.34. The Company Law which came into force in January 1989 gave most enterprises the right to establish such subsidiaries as partnerships, limited liability and joint stock companies, or economic associations.[6] The establishment of new companies was encouraged by the granting of tax abatements; starting in 1988, all new businesses, including those created on the basis of state assets, were given three-year graduated reductions in their profit taxes.[7] Capital formation was also assisted by the Foreign Investment Law. In addition to allowing for 100 percent repatriation of profits, the law permitted most Hungarian legal entities to enter, without government supervision, into joint ventures with one or more foreign investors. Enterprise managers could thus deal with foreign investors, creating new companies mixing state-owned assets and foreign capital. The resulting joint ventures were also supported by generous tax reductions.

4.35. Unlike the Company Law, which allowed only partial transformations, the Transformation Law sanctioned transformations of entire enter-

prises into joint stock or limited liability companies. In the case of self-managed enterprises, the change was initiated by a two-thirds vote of the Enterprise Council, and, until 1990, decisions to transform an enterprise, and the transformation plan itself, were not subject to ministerial supervision.[8] Enterprises with more than 50 percent of their assets invested in other companies were required to transform themselves within two years. Complete transformation was less appealing than partial transformation since it required the new company to assume the debt obligations of its state enterprise predecessor. Still, transformation held potential benefits for enterprise employees, since the Transformation Law permitted the distribution of special "worker shares" with a value of up to 20 percent of the capitalization of the newly created joint stock companies, at discounts of up to 90 percent. Overall, there were ultimately very few total transformations, and most of the new company formations involved spin-offs under the Company Law.

Results of the Transformation Process

4.36. The consequences of the last reforms of the old regime can be assessed along two separate but connected lines: (1) the changes in the organizational composition of the sector; and (2) the alterations in the distribution of property rights among the sectoral participants.

Organizational Composition

4.37. While the number of state trade enterprises remained relatively constant in the period 1988-90, confirming the fact that complete transformations played only a marginal role in this period, the impact of partial transformations was pervasive, as more than one-third of state shops changed their organizational form. The shift of shops and catering establishments occurred exclusively in self-administered enterprises or those founded by local governments. As the state enterprise sector shrank, dramatic increases were registered in both the number of commercial companies and the number of stores they operated. Limited liability companies almost doubled, with a corresponding increase in the number of shops. Growth in joint stock companies was only slightly less robust. Almost two-thirds of the 5,577 new commercial company units were added between 1989 and 1990. Foreign investors were of marginal numerical significance in the sector throughout the period; their importance was due not to the number of stores they controlled but to the prominence of their investments.

Distribution of Property Rights

4.38. Partial or complete transformation of state enterprises was often accompanied by a significant transfer of property entitlements. By May 1990, ownership and organizational transfers had both diminished the size of the state sector and created a unique set of power configurations in the remaining state-owned enterprises. Public attention focused not on the satisfaction of consumer demand, but on the need to halt the uncontrolled "spontaneous" privatization of state assets. Thus, Hungary's first post-communist government assumed power with a popular mandate to slow the pace of privatization in the trade sector.

C. Preprivatization Program

4.39. Preprivatization[9] is the only Hungarian privatization program designed specifically for the retail trade, catering, and service sector of the economy. A draft law had been prepared by the last communist government. It was driven by a need to generate income for the state budget and to end the abuses associated with "spontaneous privatization." The program envisioned the sale of a discrete portion of the state trade and service units. Shops operating under contractual or rental arrangements were the primary targets of the program. Relations between these units and their parent enterprises made real-estate operations into a core activity of some state enterprises in this sector. By selling the rented and contracted shops to independent entrepreneurs, the program would eliminate this structural inefficiency. The Preprivatization Law was not, however, enacted until 1990, and the scope of the program was reduced dramatically as a consequence of this delay.

4.40. The Preprivatization Law, which took effect on September 25, 1990, and the related legislation,[10] outlined the role of the SPA and identified the types of assets to be included in the program. Auctions were established as the sole mechanism for SPA-initiated sales. At first, all proceeds from Preprivatization auctions were to be contributed to the central state budget. Later, however, 20 percent of the proceeds from the sale of units belonging to regional institutions was given to regional governments and 50 percent of the proceeds from the sale

of local units was channeled to the local governments.

Assets in the Preprivatization Program

4.41. Sale of several types of units involved in retail trade, catering, and services was mandated by the Preprivatization Law, including: all units operating under a contractual or leasing arrangement at any time since December 31, 1988; all retail trade units employing fewer than 10 people and all catering and service establishments and hotels employing fewer than 15 people; and units involved in the sale of gas, heating oil, petrol, and diesel fuels. However, a number of exclusions removed large groups of units from the program. Categories of shops, such as pharmacies, were exempt, as were shops operating as part of a chain.

4.42. No later than 30 days after the effective date of the Preprivatization Law, state enterprises were required to give the SPA a list of all their units falling within the boundaries of the program. Many enterprises delayed reporting, while others, it seems, never reported at all. Moreover, the criteria for inclusion were vague, and a majority of large trade enterprises with potentially eligible units could have argued that their shops were part of a chain of stores and should thus be excluded from the program. It is alsonot clear whether the SPA had strong enough incentives to insist on the inclusion of a large number of units in the program. Studies performed by the Central European University Privatization Project suggest that enterprises typically engaged in substantial negotiation with the SPA, which often resulted in the inclusion of only the least valuable, often loss-making, units.

4.43. As of August 1993, 421 enterprises had reported 10,674 units to the SPA. This represents approximately one-third of the trade, catering, and service units operated by state enterprises in 1990.[11] Roughly 50 percent of the units in the program were retail shops, 30 percent restaurants, and 20 percent service establishments.

4.44. Typically, shops in the program were owned by enterprises founded by either local or regional governments. Generally, neither the shops nor their parent enterprises owned the premises on which they operated, but rented them from local governments on very favorable terms. In over 70 percent of the sales, the buyer did not acquire the title to the premises but only the right to rent for a period of 10 years. Units were sold as going concerns, and included equipment, brand names, existing contracts, and obligations of the business. Inventories were not included in sales.

4.45. As was the case with the Czech small privatization program, restrictions on the operation of privatized shops were permissible for certain categories of units. In contrast to the Czech program, restrictions could be maintained for a long period of time—up to five years. During this time, a business could change its line of activity only with the approval of local authorities.

4.46. Only Hungarian citizens or private legal entities have been eligible to purchase the assets in the Preprivatization Program. Nonetheless, there is speculation that foreigners may have participated in auctions as silent partners.

The Allocation Process

4.47. The SPA immediately assumed ownership of all units included in the program, forbidding asset alienation and depriving the enterprise of the unit's inventories. If a unit was to be sold through an auction, the SPA commissioned a private consulting firm to examine the unit's assets and make a valuation of the unit's worth. On the basis of this information, the SPA would determine the starting price for auction.

4.48. Auctions are conducted by independent agents designated by the SPA. If no bids are offered at the initial asking price, a second auction at a lower starting price determined by the SPA takes place. If the unit is not sold after the second auction, it may be sold through other means determined by the SPA.

4.49. The Preprivatization legislation stipulates that if an auction yields equal bids for the same property certain groups and interests should be given specific priority. First among these are the insiders: shop managers, employees, business associations formed by the shop employees, and employees or business associations of the enterprise to which the shop formerly belonged. These groups have the privilege, in that order, of winning any auction in which they match the highest bid. Similar preferences were also granted to purchasers offering to pay in cash. After June 1992, individuals who were parties to contractual or rental agreements involving the units in the program could avoid the auctions altogether and purchase their shops at the starting price determined by the SPA. Auction winners conclude a transfer of title agreement with the SPA within 15 days of the auction. Buyers may pay in cash or in Compensation Bonds awarded to Hungar-

ian citizens whose property was expropriated during the old regime.[12] Buyers may also obtain preferential credit under the special "E-credit" program, designed specifically to finance purchases of state assets.[13]

Results

4.50. By the end of August 1993, Preprivatization proceedings had been completed with respect to 8,723 of the 10,674 reported units, but this figure does not represent the number of units actually privatized, since in 1,707 cases ownership rights were transferred to state-owned organizations.[14] If these intra-state transfers are subtracted, 7,016 units have left the state sector through the program. Preprivatization has thus been responsible for the privatization of more than 23 percent of the state trade and catering units existing in 1990.

4.51. Of the units privatized by the end of August 1993, 4,731 were sold at auction by the SPA. This figure, however, overstates the importance of acution procedures in the program, since the SPA also classifies as auctions cases in which the current contract or rental holders exercise their option to purchase their units. We estimate that fewer than 4,000 shops were in fact sold through competitive procedures through August 1993. The remaining shops were restored to private individuals or to non-state organizations such as cooperatives, judged to be the true owners, or were sold by the enterprises to which they belonged, to repay enterprise debts.

4.52. Although these non-auction transfers decreased the revenues the state obtained from the program, they had offsetting benefits. They expedited the resolution of pre-existing property disputes which the Hungarian legal system could not otherwise process quickly and which resulted in a transfer of complete ownership rights to enterprise outsiders. It should be noted, however, that the units transferred through non-auction proceedings were among the smallest shops in the Preprivatization Program.

4.53. For the units sold by auction, the demand was limited by several non-price factors. Paramount among these was the uncertainty surrounding the transfer of the property rights. No legal provisions seem to have governed the process by which leases were negotiated after auction, except for the length of term, which was set at 10 years. This fact, coupled with the 15-day deadline for the auction winner to secure the lease from the real estate owner, created a significant imbalance in the bargaining position between the local governments (which owned the premises) and their prospective tenants. Many new owners were forced to accept the local government's rent demands or risk denial of access to their newly purchased businesses. Refusal to accept the terms offered by the local government, followed by a withdrawal of the intent to purchase, forced the auction winner to forfeit the auction deposit.

4.54. The demand for Preprivatization units was also dampened by the lack of financing. Although the E-credit program was specifically targeted to aid small domestic investors in the purchase of state assets, the commercial banks that distributed the loans supported by E-credits were cautious, demanding collateral far in excess of the amount most applicants could provide.

4.55. Preprivatization auctions appear to have served to distribute the smaller state trade units to outside investors while keeping the larger units for the most part in the hands of insiders.

D. First Privatization Program

Objectives

4.56. In September 1990, the SPA launched the First Privatization Program (FPP), its first attempt to privatize entire state-owned enterprises. The FPP was to be both a testing ground for future programs and, like the Preprivatization Program, a source of revenue for the state budget. With the FPP, it was the SPA's intent to assert its control over the Hungarian privatization process, heretofore dominated by enterprise managers.

4.57. Initially the SPA selected 20 enterprises deemed attractive for the FPP, 6 of which were in the trade sector.[15] The program had three main objectives: (1) the maximization of sale proceeds; (2) the design of the post-privatization ownership and business structure of the company; and (3) the bolstering of Hungary's capital markets.

4.58. Regarding sale proceeds, it is clear that the SPA had high financial expectations of the FPP, and the valuation of the companies in the program assumed a very high price/earnings[16] ratio (P/E) of 8 to 12, or one-and-a-half to two times the book value of the assets (estimated at Ft 73 billion: the 1990 equivalent of US$1,123 million). The privatization proceeds were intended to help pay off the state debt, and thus proceeds were not to be used to restructure the companies themselves: in only one of the six enterprises did the terms of reference

mandate an increase in the share capital as a component of privatization.

4.59. The second objective, that of shaping the post-privatization structure of the company, was reflected in the degree of detail with which the terms of reference specified the post-privatization ownership distribution, including the number of shares to be sold to foreign and domestic institutional investors, small investors, employees, foreign and Hungarian technical partners, etc. In the trade and service sector, for example, it was proposed to preserve the three chains of hotels and supermarkets included in the program in the hands of Hungarian institutional or technical investors, and to auction only minority stakes to other investors. The SPA's concerns extended not only to planning the initial ownership structure, but also to seeking ways to ensure the continued maintenance of the basic ownership pattern of domestic control. Similarly, the SPA was concerned with a number of operative details of post-privatization restructuring and required elaborate new business plans for each company.

4.60. Finally, the SPA also wanted to use the FPP to aid the development of Hungary's capital markets and it consequently placed much emphasis on the public trading (on the Budapest stock market) of the securities of the privatized companies.

4.61. The three objectives of the SPA were not necessarily complementary. Profit maximization, best pursued through attracting foreign investment, was in conflict with the objective of designing the long-term ownership structure and business plans of the privatized entities, as well as with the wish to retain certain sensitive assets of the Hungarian economy in Hungarian hands. Similarly, the development of a smoothly functioning, liquid stock market did not accord with the desire to create a semi-permanent ownership structure. Elaborate sectoral plans and extensive enterprise restructuring schemes raised the cost of the proceedings, thus also decreasing the total proceeds.

Results

4.62. Efforts to sell entire enterprises have generally failed. This has been due to a large extent to the competing objectives of the FPP. Some of the failures were also linked to the poor performance of the trade enterprises since 1990, when the value of most of the companies plummeted. Decisions regarding the proportion of shares to be sold to core investors and the timing of such sales have been the source of many problems. The privatization plans for trade enterprises generally call for a sale through a tender procedure of a significant stake in the company to one or several strategic investors, to be followed later by a sale of shares to the public. However, as of March 1993 the SPA was unable to finalize sale contracts with core investors for any of the enterprises involved. The lack of strategic sales has delayed the public offerings of shares and forced the SPA to rethink its original strategy. The SPA has had considerably greater success in selling off individual assets of the firms, plowing the revenue obained from these sales back into the companies in an effort to increase their attractiveness.

4.63. Despite some difficulties, the FPP played an important role in the subsequent Hungarian privatization efforts. On the one hand, the SPA has moved to a more decentralized approach. On the other hand, certain key ingredients in the design of the FPP (such as the focus on privatizing ongoing enterprises, the restructuring of enterprises prior to sale, and the use of non-SPA personnel) can be discerned in subsequent attempts to privatize many enterprises in the trade sector.

E. Self-Privatization

Objectives

4.64. In mid-1991, the SPA embarked on a privatization program that promised better results than the Preprivatization and First Privatization Programs. The new program involved a wide range of parties and outside expertise, and also provided a measure of bureaucratic immunity for possible failures. This new program, Self-Privatization, was not created especially for trade enterprises, but trade and service enterprises have played a pronounced role.

4.65. Self-Privatization's core feature is a shift of responsibility for transforming and privatizing (primarily small) enterprises from the SPA to private intermediaries. Within the framework of a general contract defining the responsibilities of each party, the SPA transfers the right to privatize selected state enterprises to a group of independent consulting firms. To assure the proper alignment of incentives, the SPA ties the remuneration of the participating consulting firms to proceeds generated through privatization. Additional bonus payments are linked to the speed with which the sales are completed and, for sales above the offering price, are determined by independent accountants.[17]

4.66. Self-Privatization was also designed to secure the cooperation of enterprise managers. Enterprises participating in Self-Privatization would themselves enter into contracts with the consulting firms of their choice, although they would be limited to firms pre-approved by the SPA. The consulting firms would then conduct the valuation of the enterprise and create a transformation and privatization plan. Insiders were further encouraged to participate by a system of important preferences.

4.67. In the first phase of the program, employment and turnover ceilings generally restricted Self-Privatization to small enterprises. Although trade enterprises comprised only a small portion of the program, service enterprises were prominent. Roughly one year after Self-Privatization began, the program was extended to somewhat larger firms, and the proportion of trade and service enterprises diminished.

4.68. Over 80 enterprises joined the program, motivated by, among other factors, a perception that Self-Privatization might provide the best chance for an infusion of new capital from outside investors. Trade and service enterprises, in addition, hoped through joining the program to recover some of the units they had lost to Preprivatization. But the vast majority of the enterprises involved entered the program as a consequence of being included in the lists of participants drawn up by the SPA. Although the firms are nominally free to exit from the program, such behavior is discouraged by the prospect of "forced transformation." This prospect was given added currency by the legislation passed in July 1992 that set June 30, 1993, as the deadline for the initiation of transformation in all state enterprises. Enterprises not meeting the deadline on their own are subject to SPA-directed privatization.

4.69. In the summer of 1991 the SPA invited all consulting firms registered in Hungary with either stock capital or bank guarantees of at least Ft 10 million to apply to participate in Self-Privatization. Out of an applicant pool of 150, 83 firms were chosen. Upon acceptance, the firms signed a "frame contract" with the SPA, which gave them exclusive rights to sell the shares of companies transformed through Self-Privatization. The contracts were originally scheduled to expire in March 1993, but they were extended by a second frame contract to the end of December 1993.

4.70. Results of the first phase of Self-Privatization were considered so promising that in August 1992 the SPA announced the start of the program's second phase. Forty-three consulting firms signed the second phase frame contract, which was also due to expire in December 1993.

Assets in Self-Privatization

4.71. In September 1991 the SPA announced that state enterprises with fewer than 300 employees, owning equity of less than Ft 300 million, and maintaining a sales turnover of less than Ft 300 million, could participate in the Self-Privatization program. The number of companies included in the program grew to 433 within six months.[18]

4.72. Service enterprises, broadly defined, make up 62 percent of all participants in Phase I, with consumer service enterprises comprising 43 percent. In contrast, trade enterprises constitute only 2 percent of the total, but when measured by employment and turnover, they are significantly larger than service enterprises. The second phase of Self-Privatization involved somewhat larger firms. The SPA's list of 279 eligible enterprises, published in the fall of 1992, included firms with under 1,000 employees, assets of less than Ft 1 billion, and annual turnover of under Ft 1 billion. As of June 1993, 13 of these enterprises had declined to participate. There have been no additional entries . It is worth noting that although the program's eligibility rules were changed to admit larger enterprises, the trade enterprises included in Phase II are significantly smaller than those in Phase I.

The Allocation Process

4.73. Self-Privatization involves a two-step process. First, with the assistance of the consulting firms, the enterprises are to be transformed into commercial companies (corporatized). Then, they are to be privatized through the sale of company shares.

4.74. The transformation contract signed between a participating enterprise and a consulting firm commits the firm to help the enterprise decide how best to transform. As part of this effort, the firm conducts a valuation of the company, determines which assets, if any, should be sold prior to corporatization, appeals for the return of units taken from the enterprise in Preprivatization, and sets the offering price for the company shares. A consulting firm may also determine that the enterprise is unable to satisfy its debt obligations and recommend putting it into bankruptcy. If the consulting firm determines that the company is solvent, it will

suggest a business plan for the new company. All these tasks entail extensive and time-consuming negotiations among enterprise insiders, consulting firms, and the SPA. The consulting firms must balance the interests while simultaneously weighing the need to raise additional capital for the company and to resolve the issues of future ownership quickly. Disputes between consulting firms and enterprises over business plans have at times led to the cancellation of the firm-enterprise contract.

4.75. In addition to the responsibilities related to enterprise transformation, the basic frame contracts give the consulting firms exclusive rights, until their contracts expire, to sell the shares of new companies. All sales of controlling stakes must be conducted by tender, the procedures for which are defined in SPA regulations and in legislation. All Self-Privatization sales include preferences for enterprise insiders; the general framework of these is spelled out in the privatization legislation in effect at the time of the signing of the frame contracts.

Results

4.76. The results of the Self-Privatization Program for enterprises in the trade and service sectors can be evaluated on the basis of the number of enterprises transformed and, more important, the number of enterprises privatized. Table 4.2 indicates the incidence of transformation of trade and consumer service enterprises in Self-Privatization. Overall, 126 out of the 220 trade and service enterprises (57 percent) have been transformed successfully in the two years during which the program has operated.

4.77. While transformation is simply a change of corporate form, privatization is the real objective of the program. But, as can be seen from Table 4.2, the number of trade and consumer service enterprise sold in Self-Privatization so far is modest: a total of 73, or 33 percent, out of the 220 trade and service enterprises included in the program have been fully sold. Slightly over 60 percent of the enterprises that have been transformed have later been privatized. With the exception of ESOP purchases, all sales which have taken place have been through competitive tender procedures.

4.78. As regards the buyers of the trade and service enterprises, there are no foreign investors, and the ESOPs have played only a minor role. Self-Privatization sales have been dominated by domestic and enterprise insider investors.

4.79. Almost half of the 147 not yet privatized trade and service enterprises in Self-Privatization are currently under (or have concluded) some form of bankruptcy or liquidation proceedings. The large number of enterprise terminations[19] in the trade and service sector may indicate that many

Table 4.2:
Hungary: Privatization of Trade and Service Enterprises in Self-Privatization, as of June 1993

	Trade Enterprises		Consumer Services Enterprises	
	Phase I	Phase II	Phase I	Phase II
Total No. of Enterprises	8	21	179	12
No. of Transformed Enterprises	6	14	98	8
No. Completely Sold	4	2	67	0
No. Partially Sold	0	1	9	1
Mean Value of Sale (Ft 1,000)	81,518	332,407	20,716	-
Percent of Starting Price	63.7	88.8	84.4	-
No. of Majority Stakes	4	2	54	-
Mean Size of Majority Stake(%)	83.7	75.5	85.9	-

Source: PriMan Self-Privatization data base, July 1993.

enterprises lost their economic viability with the removal of their key shops and outlets in the course of Preprivatization. But termination proceedings may also have resulted from the decisions of both enterprise insiders and consulting firms. The start of termination proceedings usually signaled the end of the consulting firm's work, and thus a conclusion to a process that has often proved to be of limited profitability for the firms. Termination proceedings also gave the enterprise insiders the opportunity to purchase valuable assets unencumbered by debt and contractual obligations. Such proceedings were involved in the privatization of approximately the same number of Self-Privatization enterprises as transformation-tender sales. The large number of enterprises in the program that remain untransformed and unsold suggests that Self-Privatization may in time become a program of privatization of individual assets through bankruptcy, rather than a sale of going concerns through competitive tenders.

F. SPA Plans for the Remaining State Units

4.80. Over 10,000 shops and catering establishments will remain state-owned even after the end of the Preprivatization and Self-Privatization Programs. The SPA is currently in the process of devising strategies for the privatization of these units. However, it is impossible to predict when and how the units will be privatized. These units are a varied assortment. Some are specialty stores that form a part of a state monopoly (these include over 1,000 pharmacies). The largest portion of the remaining units serve as retail outlets for enterprises involved in some form of manufacturing. With respect to pharmacies, the SPA plans to privatize each store separately through sales to qualified individuals. But with respect to the other remaining state stores, the SPA plans usually envision the sale of many units grouped together in chains and integrated with wholesale and distribution facilities, which would allow for economies of scale in purchasing and distribution.

4.81. In designing the new companies that will regroup the existing units, the SPA is working with officials from various ministries to produce an analysis of the particular sub-sectors of retail trade, to determine the optimal number of firms that should be formed in light of the size of the respective markets and the concentration patterns found in similar sub-sectors in Western economies. The SPA's efforts to date have achieved only modest success.

4.82. The range of difficulties encountered by the SPA is illustrated by the ongoing privatization of the KOZERT food chain. In October 1992, approximately one-half of the chain's 330 stores were sold at auction. After much debate, the SPA announced, in April 1993, its decision to create a low-priced "discount" network of food stores, and it is now seeking to attract non-profit companies to purchase the remaining stores, with the agreement that they will sell low cost food items purchased directly from producers. Neither the exact number of stores to be included nor their identity has been announced, and until the issue is resolved no sales can be concluded. The fate of the units not included in the discount chain is similarly unclear: they may be offered individually, or as part of an alternative chain, or as part of a franchise system. Similar problems in balancing a variety of interests and objectives in privatization have appeared in different guises in many of the SPA's efforts to engineer new trade sub-sectors. In the household appliance sector, for example, the privatization of a large enterprise is being held up by the SPA's desire to privatize two "competitive partners" simultaneously. Committed to an ambitious technocratic model for privatizing the remainder of the state units, Hungary is likely to continue to feature a sizable number of state-owned trade establishments for the next several years.

G. The Transformation of Hungarian Consumer Cooperatives

4.83. The recent history of Hungarian consumer cooperatives parallels, to some extent, that of Hungarian state trade enterprises. Changes in the structure of the cooperatives have been occurring for several decades and, in the last years of the old regime, a great number of stores passed out of cooperative ownership. Since 1990, significant structural transformations have taken place and there has been a large increase in rental agreements, through which the cooperatives have significantly decreased the number of stores under their direct control. The passage of a comprehensive cooperative transformation law in 1992 has resulted in a more democratic structure of cooperative governance. Overall, the number of retail and catering shops owned by consumer cooperatives has decreased between 1988 and 1992 by approximately 30 percent, from 23,187 to 16,185.

4.84. Consumer cooperatives underwent significant reforms in the last three decades of the old

regime. Beginning with the 1960s, cooperatives were substantially consolidated. At the same time, the administrative controls over the activities of cooperatives were relaxed. Finally, the management of cooperative stores was transformed through the introduction of rental agreements into the cooperative sector. By 1988, 6,119 cooperative rental arrangements were in existence, covering 26 percent of cooperative-owned establishments.

4.85. At the end of 1988, consumer cooperatives controlled over 25 percent of all the units in the trade and catering sector and accounted for approximately 30 percent of sectoral turnover. Although formal government controls over cooperatives had become relatively weak, the governance of consumer cooperatives was still not significantly influenced by the democratic organs originally designed to give the members a voice in decision-making.

4.86. The number of retail and catering units owned by consumer cooperatives dropped sharply between 1988 and 1990: the aggregate loss of 5,552 shops represented a decrease of 24 percent. This dramatic change was a result of sales and other transfers of assets by the cooperative management in the period leading up to the first free elections. The overall impact of ownership transfers on the economic position of the cooperative sector during 1988-90 was mixed. In line with the transfer of a large number of small shops, employment per unit more than tripled, leaving the cooperative stores with the highest level of employment per unit of any ownership group. At the same time, turnover per unit in cooperative-owned establishments increased by over 40 percent, but this still left it at only 50 percent of the average for the state sector.

4.87. Since 1990, the total number of units owned by consumer cooperatives has remained remarkably stable. This aggregate stability, however, masks a significant degree of restructuring. Important changes have occurred in the business management and composition of the cooperative stores, as well as in the overall governance of the cooperatives.

4.88. The institutional restructuring of the cooperative movement after 1990 has been quite impressive, although most of the changes are too recent to have had a measurable impact on business operations. Legislation in 1992 required the transformation of all cooperatives in Hungary by June 31, 1992. This legislation attempted to strengthen the ability of members to influence the governance of the cooperatives: the legislation mandated new democratic institutions, such as a more powerful supervisory board, and new elections for other representative organs. Each cooperative had a choice between re-registering under the new law or transforming itself into a limited liability or joint stock company. Groups of cooperative members could also elect to secede from the larger cooperative. Only two consumer cooperatives elected to transform themselves into joint stock companies, and 10 new cooperatives were formed as a result of secession from their parent cooperatives.[20] The new elections resulted in the removal of 14 percent of all cooperative presidents, 29 percent of managers, and 36 percent of supervisory board members.

4.89. The changes in the management and composition of the cooperative sector, however, had begun earlier. In 1990, SZOVOSZ (the Communist Party-sponsored National Federation of Cooperatives) was dismantled, to be replaced by voluntary national associations for each type of cooperative. The new National Federation of General Consumer Cooperatives (AFEOSZ) focused its attention on coordinating the economic activities of cooperatives and managing its own considerable assets.[21]

4.90. Between 1990 and 1992, cooperatives experienced an 8 percent net decline in the number of units. The actual movement of assets was much greater, as cooperatives sold some units and acquired others, and also restructured the operations of many remaining units. These changes have been generally related to an increased concern with profitability and risk diversification. Specialty shops have generally been sold off or their line of business has been changed, and the number of stores offering multiple types of goods or services has expanded. Some cooperatives fared better than others in the recent restructuring. A number were left practically "empty" as a result of having sold most of their assets. It is not possible to determine how many of these sell-offs were triggered by financial distress, but it is clear that a portion of the cooperative sector is in crisis. As of the end of 1992, seven consumer cooperatives had been liquidated because of bankruptcy.

4.91. The proportion of cooperative units rented out to private individuals grew rapidly after 1990. In the two years following the change of regime, the number of leased units went up from 4,612, or approximately 27 percent, to 7,242, or 45 percent. The leases have generally been for terms no longer than five years and have contained restrictions on changes in the line of business (but not in the selection of suppliers). A significant proportion of these leases are believed to have buyout clauses and

many rented units are expected to leave the cooperative sector in the near future.[22]

4.92. Overall, consumer cooperatives are currently in the process of diversifying their traditional focus on providing food and basic necessities to rural inhabitants. While still concentrated in non-urban settings, consumer cooperatives now own a mix of commercial establishments, offering a wide variety of products and services. They also function increasingly as real estate owners, preferring to parcel out the actual management of their stores to private parties. The designation of a store as a "cooperative" now serves more to identify ownership than to indicate management structure or social function.

Notes

1. Law No. VI of 1988 (as amended) "On Business Societies, Associations, Companies and Ventures" ("Company Law").
2. Joint stock companies usually operate as chains of more than ten units, and most of them were carved out of state companies between 1988 and 1990. Limited liability companies, in contrast, are simple structures, usually consisting of one to three units. They are likely to have been created as a means of gaining complete ownership rights over individual stores, as well as by private persons starting new commercial establishments. Unlike limited liability companies, some joint stock companies are still believed to be essentially state owned. Since most of these joint stock companies are either partially or totally owned by state entities, and since, in 1990, joint stock companies operated slightly more than 3,000 shops and restaurants, a large proportion of this figure should be added to the 17,410 establishments listed in Table 4.1 as state owned in 1990.
3. Rental agreements between enterprises and private managers were subleases since the enterprise usually did not own the premises on which its stores were located. Instead, the enterprise leased them from the local municipality.
4. See Éva Palócz, "The Emergence and Implementation of the Small-Scale Privatization Program in Eastern European Countries: The Case of Hungary," Mimeographed, Kopint Datorg, June 1992.
5. "Civil Code partnerships" focused on the provision of non-material services; members bore joint and several liability for partnership obligations.
6. Economic associations under the Company Law are entities composed of legal persons, created to coordinate commercial activity; they are not independent profit-producing entities.
7. Profit taxes were reduced by 55 percent in the first year of operations, 35 percent in the second year, and 25 percent in the third year. These tax preferences were withdrawn in 1992.
8. Registration was a judicial process, with the courts receiving the plan of transformation, the profit and loss statement, the minutes of the meetings concerning the approval of the plan, and the auditor's report on the profit and loss statement.
9. The "Preprivatization" Program owes its name to the belief that the sale of small stores was just the beginning of the privatization process, the most significant part of which was to be the privatization of large enterprises.
10. This legislation consisted of Laws No. VII and LXXIV, and several supporting documents: the Circular Letter; the Guidelines for the Sale of Assets; and the Auction Regulations. The types of assets to be included were clarified by the Circular Letter; the Guidelines for the Sale of Assets regulated the valuation of assets in the program; detailed instructions on auction procedures were provided in the Auction Regulations.
11. SPA, Department of Privatization.
12. Although Hungary has no in-kind reprivatization or restitution program, the government has awarded approximately Ft 87 billion in Compensation Bonds. These interest-bearing bonds may be used to purchase any state property privatized by the SPA, land from local cooperatives, and houses from local governments. The bonds may also be exchanged for shares in the Social Security Fund. They are freely tradable on the Budapest Stock Market.
13. E-credit is available to Hungarian natural persons and companies owned by them, for all state property purchases. Loans are refinanced by the Hungarian Central Bank and distributed by commercial banks, which typically require 150 percent collateral from any borrower. The interest rate for these loans is set at 60 percent of the Central Bank's refinancing rate.
14. Normally, only private parties can acquire units in the program. But transfer of units to state bodies occurred in some cases in which the unit functioned as a component of a larger organization. For example, where a food canteen operated within a state hospital, the right to rent out the canteen was transferred to the hospital. It is assumed that many of these units have since been sold or rented to private parties.
15. It was not possible to identify accurately the retail trade portion of some of the manufacturing state enterprises in the FPP. The decision was thus made to include here only those companies which were primarily active in retail trade, catering, and services (including the hotel industry).
16. Earnings are after-tax, assuming an effective corporate tax rate of 50 percent (which is very conservative).
17. For the Self-Privatization Program, the SPA established the subsidiary company "PriMan" (short for Privatization Management). PriMan's responsibilities include the dissemination of information to enterprises and consulting firms, the preparation of recommendations on transformation proposals, and the evaluation of the performance of consulting firms. PriMan also documents the progress of Self-Privatization transformations and sales.
18. The number of participating enterprises dropped to 421 as of the end of January 1993.
19. "Terminations" include cases of enterprises put into bankruptcy or under judicially supervised liquidation, as well as those of enterprises liquidated by a decision of the founder or by an agreement between the creditors and the enterprise.
20. *Report on the Operation of Consumer Cooperatives in 1992*, National Federation of General Consumer Cooperatives, page 2.

21. Many of the cooperative wholesale enterprises and department store units built in the 1970s were owned directly by the national organization and passed on to AFEOSZ.

22. *Statistical Data for Consumer Cooperatives for 1990*, AFEOSZ, page 35; *Report of the Consumer Cooperatives to the 2nd Congress*, 1992.

Chapter Five

Survey of Privatized Enterprises[1]

A. Introduction

5.1. The survey presented here has been in part designed to enable policymakers to draw some conclusions from the experiences of the Czech Republic, Poland, and Hungary in privatizing the retail, catering, and service sectors of their economies. In particular, it was thought that some lessons from these experiences might be drawn with respect to the prospects of small privatization in the countries of the former Soviet Union (FSU).

5.2. Some of the survey results are, of course, not geared to any policy recommendations. They attempt instead to capture the specific texture of local conditions, which may in fact be difficult to replicate in any other place. Many factors only marginally captured by the survey, such as macroeconomic conditions in the three countries and the reform of the wholesale sector, may also limit the applicability of their experience to other areas. Nevertheless, some conclusions from the study, reinforced by the survey results, have potentially important implications that merit testing in the other countries of the region.

5.3. The most important of these conclusions is a *proposed redefinition of the concept of small-scale privatization*, and the resulting recommendation for policymakers to refocus their approach to privatizing the retail and service sectors by *shifting the emphasis from the privatization of small businesses in the consumer sector to a transfer of use rights in real estate.*

5.4. Another important result of the survey concerns the role of outsiders in small privatization. The evidence collected in the survey clearly indicates that *new entrepreneurs, not connected with the predecessor retail establishments, bring in the much-needed capital, engage in significantly more restructuring, and generally serve as agents of change in the sector.*

5.5. Much of the change in the consumer sector in Eastern Europe did not come from traditional privatizations, but from an explosive growth in the size of the new private sector (which, however, often uses real estate previously controlled by the state). The growth of new businesses is even more likely to be necessary in the FSU countries, where the density of retail and service outlets in relation to population is only 20 to 30 percent of what it is in the three Central European countries and the more advanced Western economies. *If privatization is conceived as a process of releasing real estate from the state to private parties, much of the process, by including the creation of new businesses, will automatically lead to an increased participation of outsiders.*

5.6. The survey clearly supports the conclusion that the security of property rights in the newly acquired businesses is very important for the extent of post-privatization restructuring and investment in the sector. In particular, *transfers of premises on which the new businesses are located should involve either sales or leases of long duration.*

B. Population and Sample Selection

5.7. The sample population was taken from categories of economic units that were both representative of the retail trade, catering, and service sector and consistent across countries.

Population Selection

Initial Conditions

5.8. The study rationale dictated many of the initial conditions applied to the population selection. The following conditions were used for an initial screening of establishments.

- The units had to derive the major part of their income from non-manufacturing commercial activity in retail trade, catering, or services.
- The units had to operate a business (rather than solely owning real estate).
- The current owners had to have acquired their businesses through some form of legal privatization.
- The owners of the businesses had to be the initial private purchasers.
- The businesses had to have been in operation for at least one year.
- The businesses had to employ 50 or fewer individuals.

5.9. Unavoidably, the initial set of conditions resulted in the exclusion of some groups of privatized units. Also, differences among the three countries in both the pre-reform sectoral composition and the subsequent methods of privatization affected the relative importance of the uniform conditions for selection of units for the survey. In light of the delayed timing of cooperative transformation in Hungary and the Czech Republic, the requirement of at least one year of operation led to the exclusion of units privatized by Hungarian and Czech cooperatives.

Conditions Concerning the Line of Business

5.10. Concern over the potential impact of factors unique to particular types of businesses in one or more of the countries led to the adoption of a second set of selection criteria, designed to decrease the variety of the sampled businesses while maintaining the representative character of the sample population. The following categories of units were selected, on the basis of their representation in the economies of the Czech Republic, Poland, and Hungary: food stores; household necessity stores; clothing and textile stores; restaurants; and service units.[2]

5.11. A large proportion of privatized businesses fall under one of these classifications. However, some degree of sample bias was introduced through the exclusion of other types of units. Thus, for example, the exclusion of bookstores and pharmacies, both of which were frequently prevented from changing their line of business, may well have decreased the percentage of units found to operate with such restrictions.

5.12. Further, in order to ensure cross-country comparability of the sample, a quota was adopted for each category of units in the sample. In each country, the sample population was thus composed of the following ratio of businesses: 40 food stores; 20 household necessity or clothing and textile stores; 15 restaurants; and 25 service establishments. These proportions are roughly equivalent to those found in the data base for the Czech small privatization program, which was the most extensive compilation available. There was no reason to assume significant Hungarian or Polish divergence from these ratios.

Locational Distribution

5.13. Attempts were made to ensure locational distribution along two separate dimensions: geographic distribution and population density. In order to adjust for regional differences in privatization patterns, the sample population was drawn from a selected set of representative areas chosen on the basis of their proximity to national borders. In both the Czech Republic and Hungary, five regions were selected. Because of the greater degree of decentralization of the privatization process and the relatively larger size and population, 25 different sampling areas were selected in Poland. In each geographic region, the sample population was drawn from a mixture of urban, suburban, and rural localities.

Sample Selection

5.14. The sample consisted of 300 privatized establishments (units) in the retail trade, catering, and consumer service sector in the Czech Republic, Poland, and Hungary. One hundred interviews were conducted in each country, but some respondents failed to provide adequate answers to some questions.

5.15. The Czech sample was drawn exclusively from units privatized through the country's small privatization program. The Hungarian sample was selected from two separate sources. One-half of the sample was fashioned from randomized regional lists of businesses privatized through the country's

Preprivatization Program. The remaining half of the survey was chosen through a randomized list of phone numbers of units listed in the 1989 Hungarian phone directories. The sample in Poland was constructed entirely from randomized 1989 lists of state sector units existing in 25 geographically distributed census regions. The distribution of surveyed units by sector, type of location, and size (in square meters) is shown in Table 5.1.

C. Participants and Assets

Status of Interviewees/Owners

5.16. Wherever possible, the interviews were conducted with the owners of the businesses. Only in Hungary was there a significant number of general managers (21) who were interviewed. A significant characteristic of present owners was their previous status. In Hungary, 76 percent had previously been outsiders, while in the Czech Republic and Poland only 49 percent and 38 percent, respectively, had been outsiders. *The previous status of the interviewee owners was very important in distinguishing clearly between insider- and outsider-dominated firms.* This is discussed further, below.

Nature of the Conveyed Assets

5.17. Most of the privatized units were transferred to the new owners without equipment (Table 5.2). While the survey did not ask whether the privatized units had taken over a previously going

Table 5.1: Sector, Location, and Size of Surveyed Units

	Percentage of Valid Responses		
Type of Unit	Czech Republic	Poland	Hungary
By Sector:			
Shop	60	61	58
Restaurant	15	15	16
Service Outlet	25	24	26
By Location:			
Central, Commercial Area	39	41	64
Suburban Area	59	40	34
Rural Area	2	19	2
By Average No. of m² Used for Display or Service: Shop	62	75	71

Source: Survey.

Table 5.2: Parts of the Business Included in the Transfer

	Number of Units for Which a Given Part of the Business Was Transferred[1]		
Part of the Business	Czech Republic	Poland	Hungary
Premises	100	90	83
Equipment	35	36	31
Land	20	14	9
Building	28	28	29
No. of Observations[2]	*100*	*90*	*83*

[1] Number of units for which an indicated part of the business (premises, equipment, etc.) was transferred (rented or purchased). For example, equipment was transferred in 35 out of 100 transferred units in the Czech Republic.

[2] Number of valid responses, defined as responses indicating that at least one part of the business was transferred.

concern or just the assets of the old establishments, most units did not assume any debts at the time of transfer (Table 5.3).[3]

5.18. The data indicate that *small privatization is primarily not a transfer of businesses, but of assets, and more particularly, of premises or real estate.* Indeed, the decoupling of premises from the business of the state enterprises and state-dominated cooperatives intent on defending their empires — the phenomenon is particularly stark in Poland — may be one of the main factors responsible for the success of small privatization in the three countries.

5.19. The premises themselves are most often not privatized in the strict sense of the word. Since 75 percent of the privatized units lease, rather than own, the premises on which their businesses are operated, the legal title to the most important asset controlled by the majority of the "privatized" businesses in the retail and service sector is never conveyed into private hands. It is worth noting that only 12 percent of the leased premises are owned by private individuals or institutions (Table 5.4).

D. The Transfer Process

Lease versus Purchase

5.20. As was noted above, the great majority of the premises on which the privatized establishments are operating have been leased rather than sold. For the three countries taken together, some three-quarters of the survey units were leased. Moreover, there were no very significant differences among the three countries in this respect.

Features of the Rental Contract

5.21. Significant differences were found in the durations of leases among the three countries, with a median duration of 10 years in Hungary, 5 years in the Czech Republic, and only 3 years in Poland. Indeed, Poland has a very high proportion (44 percent) of leases with terms of two years or under (Table 5.5). Since short duration greatly reduces security of tenure, it is important to note whether leases contain provisions concerning renewals.

Table 5.3: Financial Obligations of Transferred Units

	Number of Units[1]		
Obligations from:	**Czech Republic**	**Poland**	**Hungary**
Suppliers for Existing Inventory	2	17	6
State Companies	21	10	5
Banks	0	6 (12)	2 (6)[2]
No. of Observations[3]	*100*	*100*	*85*

[1] Number of units that assumed obligations from an indicated creditor.
[2] Two figures are presented for the number of units answering that they assumed obligations to the banks: the number of units reporting in the survey that they assumed bank loans (in parentheses) and the adjusted set of figures. The adjusted figures are based on the presumption that respondents who answered that they assumed obligations to the banks referred to the bank loans used to finance their transfer, rather than to pre-existing obligations. It should be noted that unadjusted figures are used in the analysis of behavioral implications.
[3] Number of valid responses, defined as responses indicating that the transferred unit assumed pre-existing obligations from at least one creditor listed in the table.

Table 5.4: Owner of Rented (Leased) Premises

	Percent of Units		
Category of Owner	**Czech Republic**	**Poland**	**Hungary**
Municipality	58	21	61
Housing Coop	13	18	2
Trading/Consumer Coop	0	32	9
State-Owned Enterprise	13	14	9
Private Individual or Company	10	10	17
Other	6	5	2
No. of Observations[1]	*71*	*72*	*64*

[1] Number of valid responses, defined as responses to one of the listed categories.

5.22. While the number of valid responses is too small for confident generalizations to be made, it appears that most leases have an option to renew, but without specifying the conditions of renewal (including price), and only a small proportion of leases contain purchase options. Except in Hungary, the latter usually also fail to specify the terms of the purchase.

Restrictions

5.23. In line with the fact that most transfers concern premises rather than going business concerns, very few transfer contracts, whether leases or sales, have restrictions on change of suppliers or layoffs of employees. A substantial proportion, however, have restrictions on the change of line of business or on subletting and resale (see Table 5.6).

5.24. The restriction on the change of line of business is probably due to the fear on the part of the authorities that too rapid changes would lead to disruptions of supply.

5.25. The restrictions on subletting and resale of the premises clearly impede the operation of secondary markets and, therefore, impede improvements in the original allocation. What makes these

Table 5.5: Duration of Rental (Lease) Contracts for Premises

	Percentage of Units		
	Czech Republic	Poland	Hungary
One Year	0	22	3
Two Years	33	20	3
Three Years	2	10	6
Four Years	2	0	0
Five Years	55	37	32
Longer than Five Years	8	11	56
Average Duration (Years)	*4*	*4*	*7*
Median Duration (Years)	*5*	*3*	*10*
Number of Observations[1]	*69*	*40*	*34*

[1] Number of valid responses, defined as responses indicating durations greater than zero.

Table 5.6: Duration of Restrictions in the Transfer Contract

	Average Number of Months *(during which restriction applies)*		
Type of Restriction	Czech Republic	Poland	Hungary
Business Cannot Be Closed Down[1]	..	7	12
Employees Cannot Be Laid Off	..	12	1
Business Cannot Be Closed or Sublet	60	47	66
Line of Business Cannot Be Changed	27	47	60
Supplier Relationships Cannot Be Changed	..	60	65
Proportion of Contracts with Restrictions on Activities	*28*	*41*	*52*
Number of Observations[2]	*100*	*100*	*99*

[1] Restrictions specified by duration are measured in months. Numbers in the table contain averages across units reporting that they are subject to an indicated restriction.

[2] Number of valid responses, defined as responses indicating durations greater than zero.

restrictions even more burdensome is that their length is approximately equal to the average length of the rental contracts in our sample, and in the case of the Czech Republic even exceeds it.

5.26. The survey permits gauging to some extent the degree to which the restrictions contained in leases and sale contracts are in fact enforced by the authorities and complied with by the respondents. To begin with, a number of people who had some restrictions in their contracts (especially in the Czech Republic) stated that they were not enforced, although most said they were not easy to evade. More significantly, there is a striking difference in the behavior of people with restrictions of short duration and restrictions of long duration: while those who are barred from changing the line of business for a period of less than 50 months usually comply with their contracts, the proportion of units with long-term restrictions (over 50 months) which change the line of business is the same as among the units with no restrictions at all.

Competitiveness of the Transfer Process

5.27. Much discussion of small privatization focuses around the advisability of using competitive procedures (open auctions or tenders) as opposed to directly negotiated transfers which are likely to favor insiders and which have the potential for breeding corruption and favoritism. On the other hand, competitive procedures may be very threatening to insiders in the units subject to privatization.

5.28. The discussion in Chapter I of this report showed the modes of transfer among the three countries, distinguishing auction, direct sale, and directly negotiated rental (see Figure 1.5 in Chapter I). However, this distinction does not give the full picture of the competitiveness of the process. One may perhaps ignore the fact that not all auctions generate more than one offer,[4] since once the process is *open* to all (insider and outsider) participants, one may consider it "competitive." But many of the negotiated transfers may be competitive as well, either because outsiders are involved in the negotiations or because more than one insider is bidding for the property. In order to capture these distinctions the following terminology will be adopted in the subsequent discussions:

Open tender refers to directly negotiated transfers of premises in which outsiders (individuals not previously connected with the unit) are involved in the competition for the sale or rental.

Auction refers to an open bidding procedure in which both insiders and outsiders can participate.

Closed tender refers to directly negotiated transfers of premises in which outsiders are not involved and more than one insider is bidding for the property.

Closed non-competitive transfer refers to directly negotiated transfers of premises in which outsiders are not involved and only one insider is bidding for the property.

Open procedure refers to an auction or an open tender.

Closed procedure refers to a closed tender or a closed non-competitive transfer.

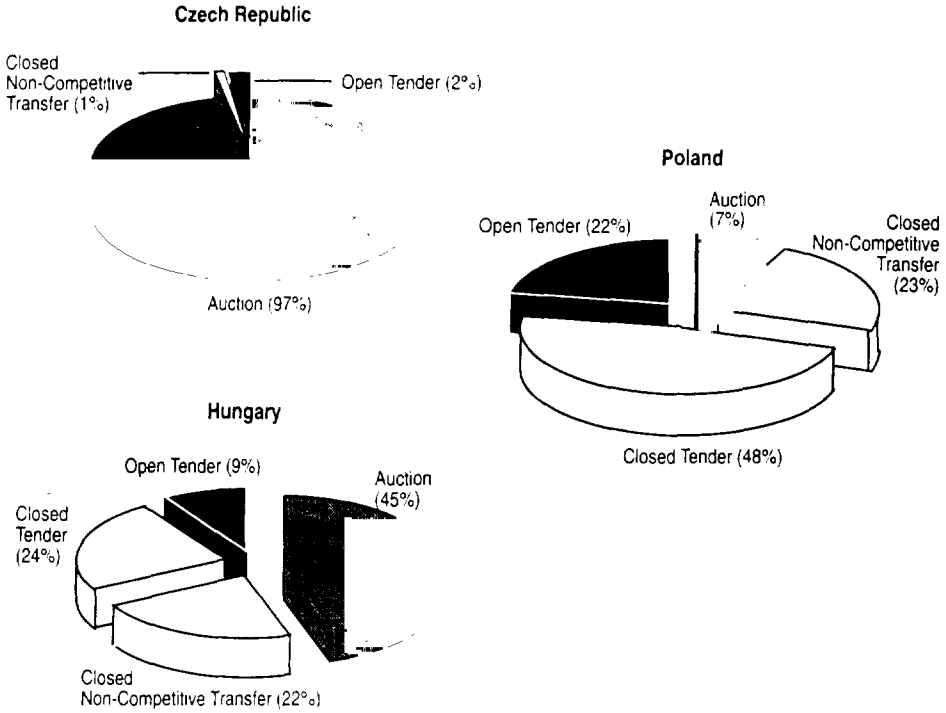
Competitive transfer or procedure refers to all forms of transfers except closed non-competitive transfers.

5.29. The size of the sample in our survey does not permit drawing conclusions concerning the degree of competitiveness in all types of transactions. But the results give a fairly adequate picture for the transfer of those units that were leased (rather than sold). In that regard, the competitiveness varied substantially across the three countries: in the Czech Republic, 99 percent were by competitive means, in Hungary, 54 percent, and in Poland, 29 percent (Figure 5.1).

Publicity for the Transfer

5.30. The publicity for the transfer is a very important feature of small privatization, especially if participation of outsiders is considered essential. The survey asked how each respondent learned about the availability of the unit, and many responses indicated multiple sources of information (advertisement in the media, government announcement, acquaintances, and internal announcement). To assess the importance of the various modes of announcement, the following ranking was established: "advertisement in the media" was counted only if it was listed as the sole mode of announcement; "government announcement" was counted only if the respondent listed it and did not list "internal announcement" or "acquaintances" as the source of information; and "acquaintances" was counted only if "internal announcement" was not listed. The purpose of the ranking was to bring out the degree of publicity accompanying each particular transfer, with the most public form of announcement, presented in Figure 5.2, treated as

Figure 5.1: Mode of Transfer of Rental Contracts for Premises[1]

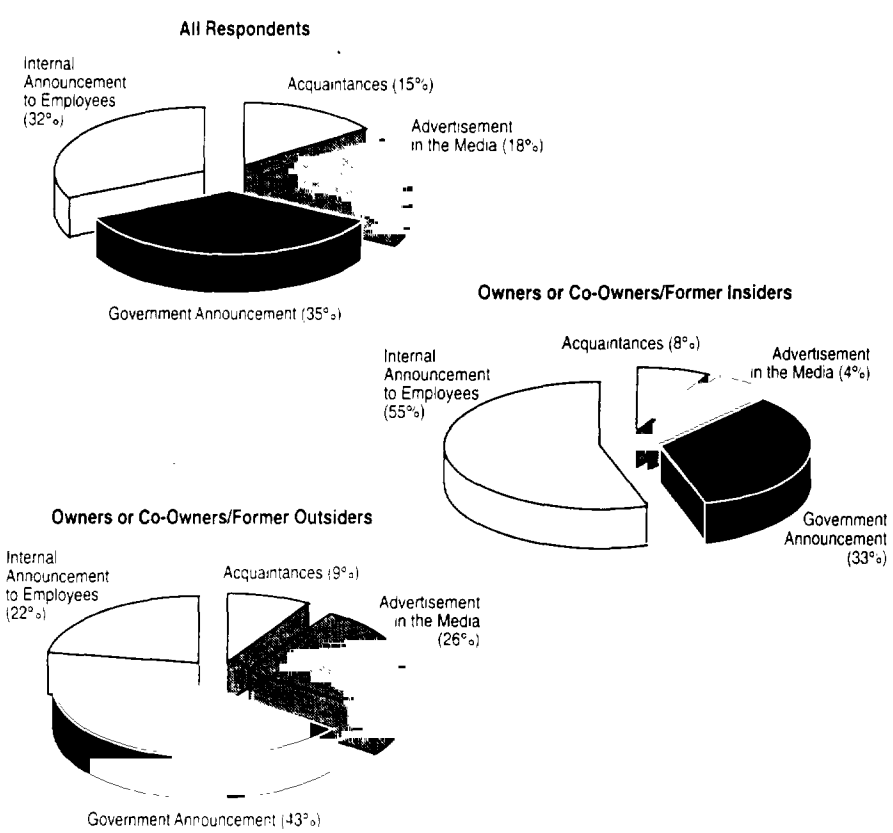


[1] Number of Observations: Czech Republic—72; Poland—69; Hungary—56.

Source: Survey.

Figure 5.2: Sources of Information About Transfers[1]

(Pooled Data)



[1] No. of Observations: All Respondents—268; Owners or Co-Owners/Former Insiders—39; Owners or Co-Owners/Former Outsiders—120.

Source: Survey.

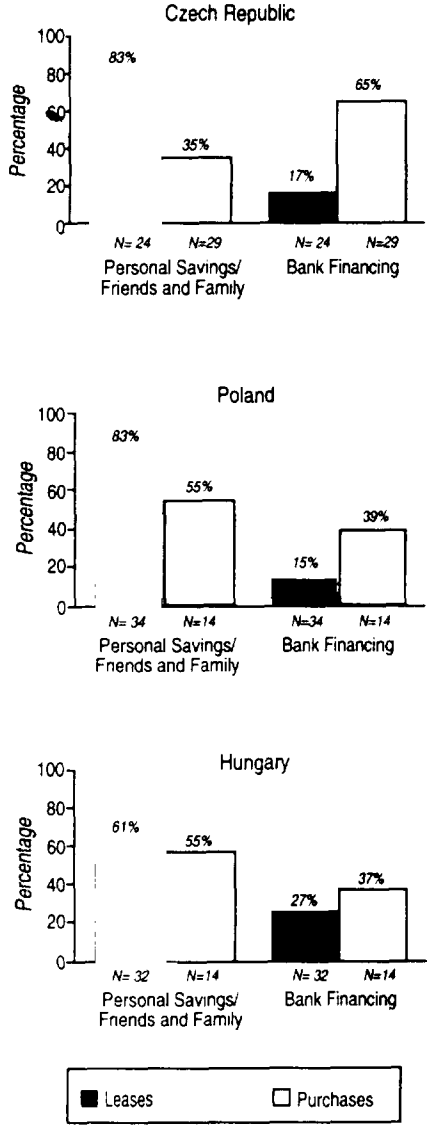
characteristic for that transfer. In particular, this ranking focused on the marginal efficacy of the announcement in the media, and allowed an estimate of how many of the present owners would not have participated in the transfer process if no media advertisement had been made. *Among the outsider owners, it is estimated that 26 percent would not have participated had it not been for the announcement in the media.*

Financing of the Acquisition

5.31. Owners of approximately 59 percent of units in the sample had to make an initial payment for the purchase or rental of the premises. In a significant proportion of cases in each country some form of collateral was required in the transfer contract. It is worthy of note that these proportions were also higher than the proportions of purchases in the sample, which indicates that a significant proportion of *rental* contracts required collateral as well. The most commonly used form of collateral was the owner's real estate (49 percent of transfers), followed by the asset itself (23 percent of transfers), and third-party guarantees (11 percent of transfers—used most often by insiders).

5.32. The data show a surprising degree of availability of bank financing for the acquisition of the premises of the privatized units. While personal savings and loans from family and friends are the main sources of financing, bank financing is used in a significant proportion of cases in the Czech Republic, Poland, and Hungary, especially when purchases, rather than leases, are involved (Figure 5.3)

Figure 5.3: Financing of the Transfer Contracts for Premises



N denotes sample size.

Source: Survey.

E. Post-Transfer Behavior and Environment

5.33. The post-privatization behavior of the transferred units may be thought of as dependent on three basic factors: the environmental constraints faced by the units, the effects of the transfer process, and the post-transfer ownership structure. In this section, we will provide a picture of the environmental conditions in which the privatized units operate.

Quality and Choice of Suppliers

5.34. The relationship between a revitalization of the retail sector in consumer trade and the reform of the wholesale sector is an often-debated "chicken-or-egg" problem. According to one point of view, the rapid privatization of the retail sector is bound to produce dramatic changes in demand in the wholesale sector and induce necessary upstream restructuring. According to another point of view, however, the reform of the retail sector has a very low plateau of possible improvement in the supply of goods to the population unless the wholesale sector is previously, or at least simultaneously, demonopolized and made to perform at a higher level of efficiency.

5.35. The survey contains only limited information bearing on this issue. It should be noted, however, as a caveat to our description of the changes in the retail area, that the process of reform in all three countries examined has proceeded simultaneously in the retail and the wholesale sectors. For this reason, some of the results detected in the sample may not be easily reproducible in other countries of the region, where resistance to the reform of the wholesale sector may be stronger and change may be slower in coming.

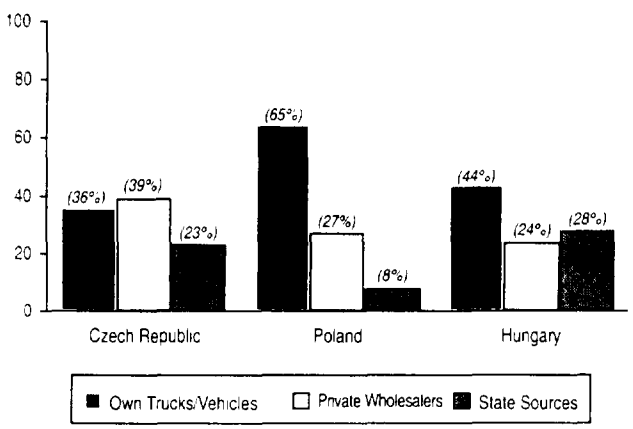
5.36. Having said this, it should be added that the survey is not without implications for the debate on the relative priorities of the reform in the retail and wholesale sectors. In fact, it provides some evidence for both points of view, although the evidence for the "upstream push" through the reform of the retail sector is somewhat more direct and perhaps stronger.

5.37. The strongest evidence for the existence of an "upstream push" can be seen in Figure 5.4, which reports the proportions of supplies delivered to the retail units in the sample through various means of transportation.

5.38. The most striking feature of the figure is the high proportion of supplies delivered by own trucks/vehicles, which reaches 65 percent in Poland, which indicates that private retailers can organize a very effective substitute for a functioning system of wholesaling (depending, of course, on the availability of transport). In Poland many state enterprises, in the wake of tightening budget constraints, sold off part of their stock of trucks to private individuals; this increase in supply led to a rapid expansion of the new private wholesale sector. While we have no information on the source of the large number of private trucks in use in Hungary and the Czech Republic, the proportions of own trucks indicates that the very fact of "upstream demand" may be a significant factor in generating increased supply.

5.39. With unconstrained choice, retailer perceptions of the quality of various sources of supply drive the shifts from one source to another. It was important, therefore to examine the way in which

Figure 5.4: Mode of Transport Used for Supplies[1]



[1] Number of Observations: Czech Republic—98; Poland—100; Hungary—97.

Source: Survey.

retailers in the three countries viewed the relative merits and demerits of the private and state suppliers. For this purpose, respondents in each country were asked to evaluate each source of supplies (state, cooperative, and private) along six dimensions: price, timeliness, assortment of goods, quality of goods, terms of payment, and extension of supplier credit. Each supplier could be ranked as "best" or "worst" on each dimension.

5.40. In all three countries, the respondents as a group nearly uniformly ranked private suppliers above the state ones in all dimensions — only in one case and in one dimension (extension of credit in the Czech Republic) were state suppliers ranked significantly higher than private ones. The rankings of private suppliers become even higher when only previous outsiders are polled, which points to the slower pace at which the old managers in the state sector change their minds.

5.41. Some of the highest ratings of private suppliers were noted in Hungary. Yet Hungary is the country with the lowest proportion of supplies provided by the private sector. The reasons for this can only be conjectured, but this phenomenon might support the "downstream drag" view of the relationship between retail and wholesale sectors: the Hungarian wholesale sector may still be dominated by large state suppliers that enjoy local monopolies in some areas, and many retailers may have to use them regardless of the quality of their services.

5.42. Overall, however, retailers in all three countries have moved decisively away from state suppliers. The change is particularly pronounced in the Czech Republic and Poland.

Financing of Operations

5.43. The most striking feature of the data on post-privatization financing in the survey is that credit from suppliers is virtually unavailable for financing working capital.[5] Supplier credit is the usual mode of financing retail businesses in mature economies, since monitoring small businesses is too costly for banks and other creditors in relation to the size of the loan. Suppliers, on the other hand, because of their ongoing relation with the retailers, are in a better position to oversee retailers' activities.

5.44. The absence of supplier credit in Eastern Europe is most likely due to high interest rates coupled with the newness and transitional state of many of the relationships between suppliers and new owners of retail establishments. The turmoil in the wholesale sector is probably a contributing factor as well.

5.45. Equally striking is the minor role played by the banking system in the financing of long-term investments. The Czech Republic is the weakest on this score, with only 9 percent of investments financed by the banks. The figures are only slightly higher for Hungary (18 percent) and Poland (26 percent). Not surprisingly, bank financing of working capital is even more limited, at 4 percent in the Czech Republic and 11 percent in Hungary and Poland.

5.46. The scarcity of bank financing for investment appears to be one of the important factors affecting investment levels and ownership structure of small businesses in the area. Where financing is unavailable and individual wealth is small, individuals wishing to expand their businesses must turn to other equity contributors and change the structure of ownership of their businesses. This effect is very pronounced in our sample, where partnerships in Poland and Hungary[6] invested significantly more in the remodeling of their units following privatization: while individual owners invested, on the average, $4,199, partnerships invested $6,349. The difference is still more pronounced when only outsider owners are considered; the sample mean of investment for partnerships then skyrockets to $8,224. At the same time, partnerships formed by insiders show even lower levels of post-transfer investment ($3,124), probably because their formation was motivated more by the need to share preferential acquisition terms than by the need to pool investment resources.

Employment Patterns

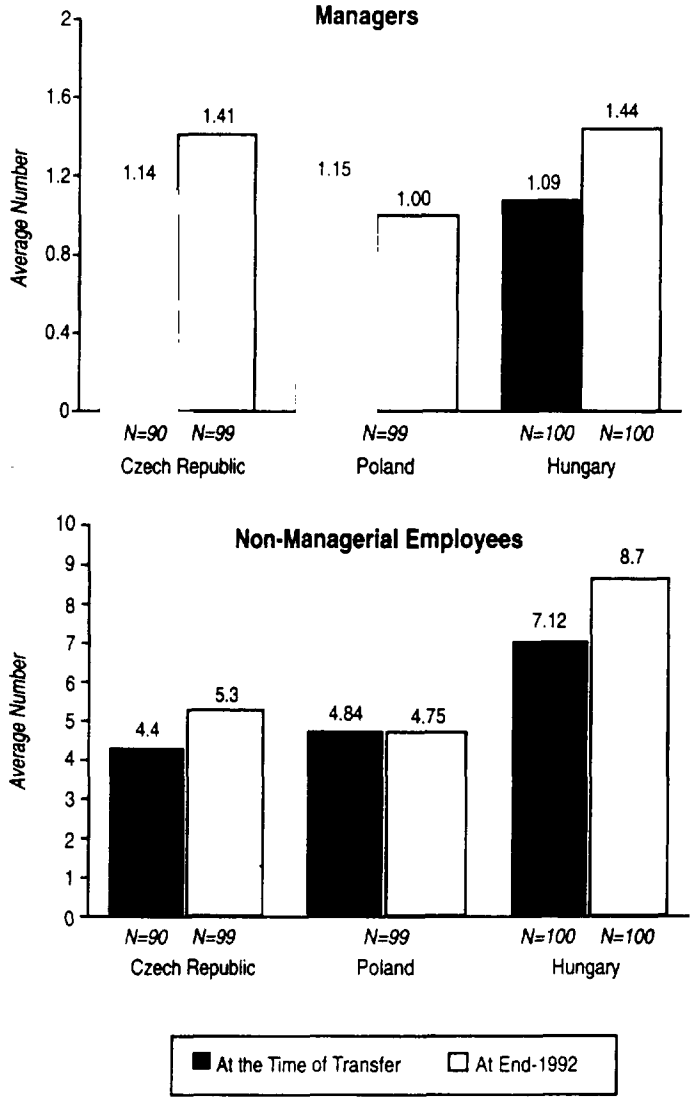
5.47. It is interesting to note that in both Hungary and the Czech Republic the average employment per unit in the sector is growing, but this is not the case in Poland, where the number of managerial and non-managerial employees is slightly smaller than it was at the time of transfer (see Figure 5.5).[7]

5.48. A strong increase in the ratio of managerial to non-managerial compensation, observable in all countries and reported in Table 5.7, should be taken as positive evidence of post-privatization restructuring. Given the relatively flat compensation curve characteristic of the old system, the change is likely to result in a significant modification of managerial incentives.

5.49. The survey also provides information on the fate of former managers and employees. The num-

Figure 5.5: Average Employment

(Per Unit)



N denotes sample size.

Source: Survey.

Table 5.7: Ratio of Managerial to Non-Managerial Compensation

Change of Ratio of Managerial to Non-Managerial Compensation	Percent of Units		
	Czech Republic	Poland	Hungary
Large Increase Since Transfer	13	5	3
Moderate Increase	23	34	18
Unchanged	48	39	50
Moderate Decrease	1	7	7
Large Decrease	0	0	0
No. of Observations[1]	*100*	*100*	*96*

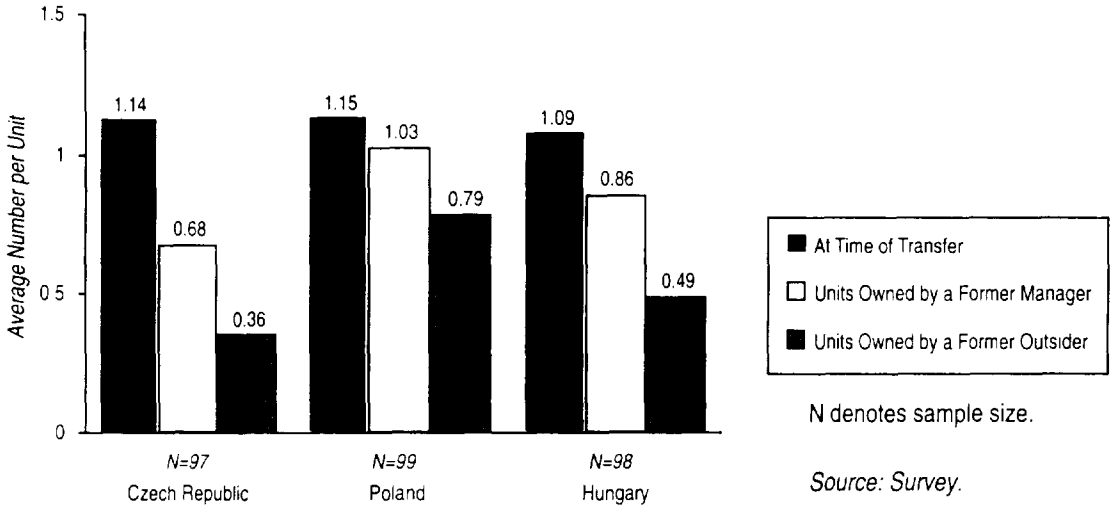
1 Number of valid responses, defined as responses to at least one of the listed categories.

ber of former managers who are fired after the transfer varies considerably by country. As is shown in Figure 5.6, the Czechs, both insiders and outsiders, are much more likely to fire former managers, and the outsiders are particularly brutal in applying the axe. By contrast, in Poland, even in units taken over by outsiders, the rate of retention of previous managers is relatively high.[5]

Perceptions of the Environment and the Role of Government

5.50. The respondents' perceptions of the constraints imposed on them by the environment in which they work (see Table 5.8) confirm some of the analyses in the previous sections of this survey and raise other interesting issues.

Figure 5.6: Average Number of Former Managers Employed
(At time of Survey)



N denotes sample size.

Source: Survey.

Table 5.8:
Perceived Work Environment Constraints

Type of Constraint	Perceived Constraint (Number of Respondents)[1] Czech Republic	Poland	Hungary
Strong Competition	13	50	50
Government Regulations and Interference	54	10	51
Poor Quality of Existing Workforce	15	8	13
Shortage of Labor	11	4	12
High Cost or Lack of Credit	83	74	77
Limited Availability of Supplies	23	4	16
Problems with Delivery of Supplies	22	4	11
Inflation or Price Stability	58	83	78
Lack of Demand	25	65	59
Lack of Foreign Exchange	0	4	2
Political Stability	11	26	19
Corrupt Government Officials	14	13	8
Difficult Bureaucratic Procedures	53	24	44
Lack of Procedures to Enforce Contracts with Customers and Suppliers	11	7	7
Legal Uncertainty	31	64	30

1 Number of respondents listing a given constraint as a critical one affecting their operations.

5.51. The two most significant constraints perceived by the respondents in all three countries were clearly lack of available credit, and inflation (which could also be related to the high interest rates of financing). It is interesting to note that strong competition and the lack of demand for goods are serious concerns in Poland and Hungary, while they appear much less important in the Czech Republic, where the sector may not yet be fully developed.

5.52. The respondents evidently do not see government corruption or political instability as very important factors, but both the Czechs and the Hungarians worry about governmental interference and bureaucratic obstacles (both of which seem to be relatively minor concerns to the Poles). Contrary to the concern of many Westerners, the respondents do not seem to be very worried by difficulties with contract enforcement, but they do worry quite a lot (especially in Poland) about "legal uncertainty," by which they most probably mean the insecurity of property entitlements.

F. Behavioral Implications of the Transfer Contract

5.53. This section and the next two sections (sections G and H) will focus on the effect of various features of the transfer process and post-privatization ownership structure on the behavior of the privatized units following the transfer. The study will be primarily centered around one outcome variable — the level of investment in the wake of privatization

Levels of Investment and Restructuring in the Sample

5.54. Investment in the remodeling of premises in the wake of privatization is used in this study as a proxy for long-term investment in the unit. The physical stock of the consumer trade and service outlets under the old regime was rundown and woefully inadequate to satisfy the needs of the population. While the elimination of shortages and the increase in the assortment of goods was the most pressing need in countries such as Poland, a sizable investment in the remodeling of the premises, improving their appearance and functionality, and furnishing them in accordance with the standards customary in Western countries was necessary to bring the consumer retail and services sector up to par. Therefore, using the level of investment in remodeling as a proxy for post-privatization restructuring appeared as a sensible procedure.

5.55. The sample means of the levels of investment in remodeling in U.S. dollars[9] in each of the three countries are $4,390 for the Czech Republic, $4,156 for Poland, and $6,017 for Hungary, and the average for all respondents is $4,835.

Debt and Its Impact on Investment

5.56. One of the decisions to be made in the context of small privatization is whether units in the sector should be liquidated and their assets sold to private parties, or whether they should be privatized as a going concern. One of the arguments against privatization of going concerns is that saddling new owners with the obligations of old state businesses may interfere with their restructuring efforts.

5.57. The survey has not yielded conclusive results concerning the impact of indebtedness at the time of transfer. Although the sample mean of investment for units with no financial obligations ($5,065) is higher than that for the indebted units ($4,109), the difference is not statistically significant.

Impacts of Contract Uncertainty and Lease Restrictions

5.58. Another important feature determining the level of investment is the degree of uncertainty of the title to the most important assets of the business: the premises. When the pooled sample for all three countries is considered, *the respondents have a pronounced preference for outright ownership over lease contracts*, and the businesses that own their premises show much higher mean levels of post-privatization investment (Figure 5.7).[10] Even an option to purchase raises the mean level of investment in our sample, but this result is not statistically significant.

5.59. There are several possible explanations of the preference for purchases over leases. One is the tenant's weak bargaining position vis-à-vis the landlord, who is often a municipality or a powerful state institution, frequently with a near monopoly on the real estate of a given kind. In this situation, the new tenants might well fear that the landlords might use their market position to extract all types of unexpected concessions.

5.60. But there may also be another explanation: namely, the fact that rentals, especially in Poland

and the Czech Republic, are usually of very short duration (a sample mean of four years, with a large number under two years). Indeed, a closer examination of our sample reveals that the preference for purchase over leases is very pronounced in Poland and the Czech Republic, but not in Hungary, where the average length of rental is seven years.

5.61. Independent evidence in the study also shows that *contract duration is one of the crucial driving forces of post-privatization investment*: units with leases with terms longer than five years had, on the average, more than double the investment rate of units with leases shorter than five years: $5,272 versus $2,687.

G. Behavioral Implications of the Competitiveness of the Mode of Transfer

5.62. Perhaps the most frequently debated issue, and one of the most important questions for policymakers, in the context of small privatization is whether granting preferences to former employees in the acquisition of the privatized units adversely affects the behavior of the those units in the wake of the transfer. This issue can be broken down into two related problems: (1) whether a competitive transfer process allocates the privatized units to significantly more effective new owners, and (2) whether insiders are less effective in restructuring the privatized units (in terms of investment levels, adaptation to new market conditions, improvement of assortment and service, etc.).

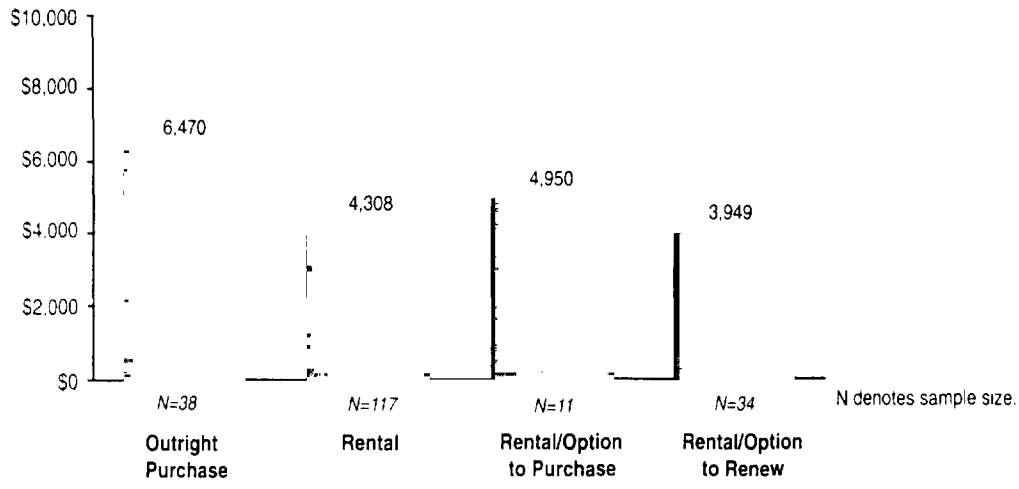
5.63. Open procedures (auctions and open tenders), when looked at only from the point of view of whether they result in a better allocation of the privatized units, seem to be significantly preferable to transfers with no outsider participation (closed procedures), since, as is shown in Figure 5.8, *investment in units transferred through open procedures is, on the average, significantly higher.*

H. Behavioral Implications of Post-privatization Ownership Structure

5.64. As is shown in Figure 5.9, *outsiders, on the average, invest much more than insiders.* Moreover, the effect of the ownership structure persists regardless of the method of transfer, so long as outsiders are allowed to participate at all.

5.65. The superiority of outside owners is not surprising. To begin with, outsiders, being a self-selected group of entrepreneurs, probably have more capital than do former employees in what was traditionally a low-paying sector in Eastern European economies. Also, outsiders are less likely to be set in the old ways of doing business, and this makes it more likely that they will institute changes that will lead to a greater amount of remodeling.

Figure 5.7: Effects of Contract Uncertainty on Investment in Remodeling of Premises
(Pooled Data)



Tests of the differences between the following Means of Investment (MINV):

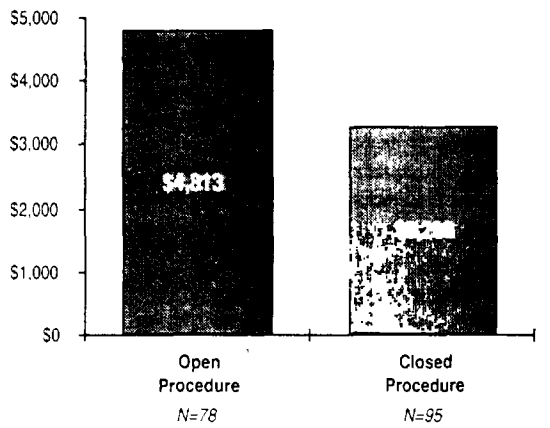
MINV (Outright Purchase) > MINV (Rental); P-Value = 3%
MINV (Rental/Option to Purchase) = MINV (Rental/Option to Renew)

Source: Survey.

5.66. In addition, the survey results were used in a simple multivariate analysis of the relationship between investment in remodeling of premises and duration and post-privatization ownership arrangements, as well as other factors considered in this and the previous sections: mode of transfer, price ratios, purchases versus rentals, country-specific dummies, etc. All variables except the variables for long and short duration and post-privatization ownership arrangements turned out to be insignificant.[11]

5.67. Even after the effect of duration on investment is controlled for, and despite the finding that outsiders' rental contracts have longer durations, the effect of outsider ownership on investment in remodeling of premises following privatization remains significant.

Figure 5.8:
Competitiveness of the Transfer Process and Investment in Remodeling of Premises
(Pooled Data)

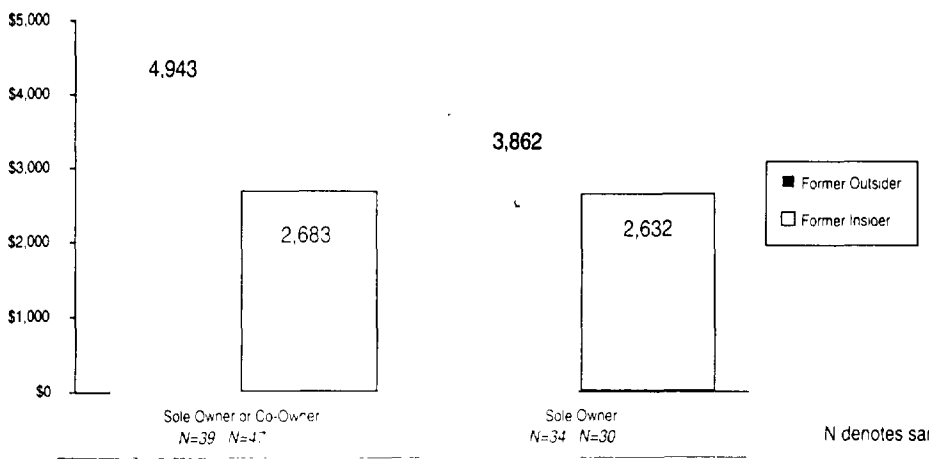


N denotes sample size.

Test of the difference between the following Means of Investment (MINV):
MINV (Open Procedure) > MINV (Closed Procedure). P-Value = 5%

Source: Survey.

Figure 5.9:
Outsider and Insider Investment in Remodeling of Premises
(Pooled Data)



N denotes sample size.

Tests of the differences between the following Means of Investment (MINV):
MINV (Sole Owner or Co-Owner/Outsider) > MINV (Sole Owner or Co-Owner/Insider), P-Value = 5%
MINV (Sole Owner/Outsider) > MINV (Sole Owner Insider), P-Value = 7%

Source: Survey.

Notes

1. This chapter is taken from a more detailed joint study of the Central European University Privatization Project and the World Bank.
2. Classification was based on the activity from which the business derived more than 50 percent of its revenue. Food stores were defined to include stores selling both fresh and processed foods. A "store" was defined as a business unit with a window located in a permanent structure; thus it was distinguishable from kiosks, street vendors, and other types of commercial outlets. A "household necessity store" was defined as a store selling non-durable household goods. "Restaurants" were defined to include all catering establishments serving food. Excluded from "service units" were all businesses providing services such as law or accounting offices.
3. Some units had confused the debts of previous establishments with debts to finance the transfer. After correcting for this confusion, it appears that no more than 18 percent of the units in all three countries assumed any obligations of the pre-existing state or cooperative establishments.
4. In fact, 25.7 percent of auctions in our pooled sample did not generate more than one offer. It should be noted that the number of offers is dependent not only on the openness of the process, but also on how high the starting price is. Thus, for example, in the Hungarian sample, heavily skewed by the proportion of units in the Preprivatization Program, in which starting prices were set relatively high, over 44 percent of transfers did not generate more than one offer, even though the process was quite open and resulted in the highest proportion of outsider-owners among all three countries.
5. In the Czech sample none of the working capital is reported as financed by suppliers, while the figures for Hungary and Poland are 5 and 7 percent, respectively.
6. There were no partnerships in the Czech Republic sample.
7. The changes over time in the average number of employees per unit should not, however, be taken as an indication of the overall changes in employment in the sector; in fact, the number of units in all countries grew exponentially in the wake of the reforms, and the consumer sector represents one of the few dynamic areas of growth in the three economies.
8. While the retention rate of former managers in Poland has been high, the survey contains evidence that overall labor turnover in Poland has also been very high, with 43 percent of managers and 76 percent of non-managerial employees fired since the transfer. This may be considered as evidence of restructuring and perhaps also as an indication of a shift in power from the workers to the managers.
9. The following exchange rates were used in this study: Kc 28 = $1, Ft 75 = $1, Z1 13,000 = $1.
10. "N" in this and other figures denotes the sample size. About 25 percent of the respondents did not report the levels of investment in their units. The units with missing observations were excluded from the sample.
11. The estimated regression model, retaining only significant variables for the sample of rentals, is as follows:

INVESTMENT IN REMODELING OF PREMISES
= 4,972 + 2,211*SMSO - 2,947*DURX
(.0436)(.0416) (.007)

where,

DURX = 1, if duration > 5
= 2, if duration <=5

SMSO = 1, if the establishment is solely owned by its former manager
= 2, if the establishment is solely owned by a former outsider.

As is clear from the p-values (noted in parentheses under the coefficients), both dummy variables are highly significant. Regarding DURX, since the relationship between duration and investment appears to be nonlinear, this dummy variable was used to estimate approximate effects of long- and short-term leases.