# THE PRIVATIZATION OF THE POLISH ECONOMY

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Privatizing Poland's economy requires structural changes of unprecedented magnitude. In 1987, Polish state enterprises held 81 percent of all fixed non-agricultural assets, employed 68 percent of nonagricultural labor, and accounted for 82 percent of nonagricultural value added. Cooperatives accounted for another 11 percent of fixed assets. Thus, except for agriculture, the socialized mode of ownership prevailed.

Privatization also raises difficult issues of equity and efficiency. Under socialism the means of production belong, in principle, to society as a whole implying an egalitarian distribution of assets. Moreover, special-interest groups, in particular, workers who acquired a significant share of property rights during the 1980s, are now making claims on productive assets in addition to former property owners. Efficiency considerations, however, suggest the need for a concentration of capital and production assets.

Finally, private ownership requires a transition from severe price distortions which virtually preclude asset valuation, and constitute a serious deficiency, to reliance on a market mechanism.

The remainder of this paper describes how Poland has met the challenge of privatization. The first section describes the evolution of property rights under Communism. The second section outlines the government program of 1989-1991, and is followed by a description of its implementation. The paper closes with some concluding thoughts.

## THE STRUCTURE OF PROPERTY RIGHTS BEFORE 1989

Poland's Soviet-type command economy system rested on three pillars — state ownership of productive resources, a centralized-hierarchic administrative system, and Communist Party hegemony. The bulk of Polish agriculture remained in private hands, but otherwise private enterprise played a marginal role in the Polish economy.

State-owned enterprises were subject to centralized, complex, and highly politicized control. Decisions made by bureaucrats far removed from the production line were executed at lower levels of the hierarchy. Even worse, the enterprises supplying production information and the bureaucracy manipulated information to change targets. Planning was a "game" between command givers, who sought to maximize target fulfillment at minimum input, and plan executors, who sought to minimize targets given the resources.

At the same time, enterprise governance was highly politicized. Only members of the "nomenklatura" (individuals accepted by the Party) could qualify for appointments and promotions. In addition, many economic decisions were considered to be political and were made by political bodies. The command structure was very complex, and the government administration was intertwined with the Communist party apparatus. Since the Party monopolized power, there was no clear distinction between Party and State authority, or between Party and State ownership rights. The Party-State as the sole owner could, and frequently did, intervene in the management of individual enterprises.

Finally, the system was plagued by incentive problems. The State sector was shielded from market pressures, while the confusion of lines of authority and the politicization of governance reduced the effectiveness of administrative control. The resulting inefficiencies helped precipitate the economic crisis of the late 1970s and forced the Communist Party to seek reforms.

Under the State Enterprise Act of 1981, enterprises received considerable autonomy. They were permitted to select sources of supply, make assortment decisions, market their product, and even decide how to invest retained profits.

The Act provided for power-sharing between the Enterprise Manager and the Employee Council. This arrangement reflects yet another compromise between managerial control and worker management. In Poland the idea of worker management first gained popularity in 1956, after the political changes which marked the end of the Stalinist era. The movement was quickly suppressed by the Communists, however, fearing that worker management would undermine their authority. During the pre-1981 martial law period, Solidarity sought to strengthen Employee Councils by reviving the idea of worker management. Some Solidarity activists viewed the Councils as a shield against the Party and its bureaucratic interference in management, while others regarded them as a means of achieving "genuine" socialism. Both rationales, though, contemplated less government control, thus resulting in Party opposition to worker management. To defuse this issue, a compromise law formalizing the division of power between managers and Employee Councils was passed.

Prior to these reforms, enterprise managers were functionaries entrusted with the execution of bureaucratically determined programs. The State Enterprise Law granted managers wide discretion, but also subjected them to Employee Councils, which had the right to amend annual enterprise plans, determine the use of net profits, and make investment decisions. The Councils also could decide to split or merge enterprises in non-strategic industries, participate (with the Funding Organ) in the appointment or dismissal of enterprise managers. Such autonomy gradually was extended to virtually the whole economy.

In summation, the reforms of the 1980s defined State Enterprises as distinct entities. By steering a middle course between advocates of the command system and those of social ownership and of decentralization, the government failed to clarify



the issue of ownership rights. If anything, the situation became more complicated — property rights were shared by the State and by enterprises, while management was made responsible both to the State and to Employee Councils.

## THE STRATEGY OF PRIVATIZATION

From 1986-89 the Communist Party allowed a lively academic debate on possible changes in the structure of ownership. Various solutions — including the laissez-faire approach, returning all state-owned property to its original owners, the transformation of state-owned enterprises into government-held joint stock companies, and the development of employee-owned companies — were contemplated. This debate continued after Solidarity took over, but was largely foreclosed by the new government's declaration that restoring private property was an integral part of the reform program.

The strategy ultimately adopted was a compromise between the various positions advanced during the privatization debate. Its legal framework is contained in the Act on the Privatization of state-owned Enterprises, which stipulates that a state-owned enterprise is to be transformed into a corporation, with the Treasury as the sole owner of all shares, before transferring the employees to private ownership. In this fashion, any monies from subsequent privatization would belong to the Treasury.

Commercialized enterprises must be privatized within a two-year period. Upon privatization, employees lose the right to appoint directors to the board, but they may buy up to 20 percent of their company's stock at 50 percent of the public offering price, provided that the subsidy element does not exceed the average annual pay in the public sector. Thus, if employees exercise their rights, they may retain a substantial influence over management.

The Act also provides for privatization-through-liquidation. The Funding Organ may ask the Minister for Ownership Transformation to liquidate a State enterprise. The assets of a liquidated company may be sold, used for the formation of a new company, or leased to a company. The successor company must have among its shareholders a majority of the employees of the liquidated company.

Foreign investors are permitted to freely purchase up to 10 percent of the shares in a privatized enterprise. Larger purchases of stock and preferred shares require approval of the Agency for Foreign Investment. This clause is the result of yet another compromise. The need to attract foreign capital, technology, and managerial skills is widely recognized. At the same time, though, there are widespread fears (strongly articulated by certain political groupings) that foreigners will buy up Polish industry for next to nothing.

The privatization program drawn up to implement the Privatization Act was approved by Parliament in February 1991. Its aim is to transfer half of state-owned assets into private hands within three years and to achieve an ownership structure similar to that of Western Europe within five years.

Selected medium-sized or large financially sound enterprises with good export prospects are to be privatized on a case-by-case basis. These enterprises will be carefully valued by independent consulting firms, and their shares may be offered to the public by prospectus. The Ministry for Ownership Changes intends to retain a block of shares in each enterprise, which it will sell to a "core investor" able to exercise managerial control. In some instances, all the stock in a firm may be sold to a foreign group or a single foreign investor. This is likely to occur in cases where foreign capital, management, and technology are deemed indispensable. A swap of Polish debt for equity in privatized enterprises is also possible.

The novelty of the February 1991 scheme lies in its proposed mass privatization of large enterprises. (The 500 largest enterprises account for about 40 percent of State enterprise employment and 65 percent of the total value of output.) The proposal outlines the distribution of privatization vouchers to the entire population, as foreseen by the Privatization Law. The vouchers were to be used to purchase shares of (yet to be formed) closed-ended Privatization Funds. These, in turn, would use the vouchers to purchase enterprise shares from the Treasury. Sales would be arranged so that every enterprise would be under the control of a Fund. A payment scheme was to induce Fund managers to improve enterprise profitability under their tutelage and to sell them off. Having served their purpose, the Privatization Funds would convert to open-ended Mutual Funds.

The idea behind the scheme was to provide for a widespread distribution of ownership and concentration of control. The population would use the vouchers to acquire diversified portfolios rather than shares of individual enterprises, thus reducing the risk to Polish investors. This is important given the lack of information on the worth of individual enterprises and the lack of investor sophistication. Under the scheme, the problem of initial valuation would be minimized, since the Privatization Funds would use vouchers, rather than money, to pay for enterprise shares. Privatization could proceed rapidly, without regard to the absorption capacity of the financial market. The Privatization Funds could bring in foreign managerial expertise, but the productive assets would remain in Polish hands.

The government of Krzysztof Bielecki, which succeeded that of Tadeusz Mazowiecki (who resigned after being defeated by Lech Walesa in the presidential election), accepted the general idea of the mass privatization scheme and undertook to make it operational. Some of the original ideas — e.g., that voucher holders could choose to exchange their vouchers for shares in the Fund of their choice — proved to be impractical (how would a voucher holder know which fund to invest in, if the funds had no track record?). Approaches having desirable economic and social features (social equity, wide freedom of choice, safeguards against manipulation and fraud) were found to be too costly to implement. Workable schemes, however, often were unacceptably arbitrary or potentially unfair. Many other issues barely touched upon in the February 1991 document proved to be extremely thorny. For example, what should be the structure of the Funds, and how should their activities be supervised?

The final version of the "Mass Privatization" program, issued in June 1991, retains the principal features of the earlier proposal, though it calls for a simplified institutional structure. Specifically, instead of vouchers, all Polish citizens over 18 years old and residing in Poland will receive one share in each of the Investment Groups that are to be formed. The Groups will obtain about 60 percent of the shares in enterprises to be privatized (10 percent of the shares will be given to the workers for free, and 30 percent will be retained by the Treasury). A controlling packet (33 percent) in every enterprise will be held by one Group, while the remaining 27 percent will be allotted to other Groups in small packets.



The Groups will function as closed-ended funds. They will be joint ventures with a Polish Board of Directors that will conclude managerial contracts with, and exercise supervision over, foreign investment banks selected to run the funds. The first Boards will be appointed by the Government; after the first financial results are published (foreseen for 1993) the appointment power will pass to the stockholders. As in the earlier proposal, the Groups will have all the standard ownership rights of corporate shareholders.

The Mass Privatization Scheme will include 400 large enterprises, accounting for 25 percent of all sales and 12 percent of all employment in the manufacturing industry. Excluded are enterprises on the verge of bankruptcy, and certain branches of industry, such as coal mining and steel, for which comprehensive restructuring programs are being prepared. The 400 selected were to be "commercialized" before the end of 1991 and privatized early in 1992.

The privatization of large enterprises is a striking manifestation of real change, but most state-owned units (some 5,500 to 6,000) are small and medium-sized companies. Their privatization is being carried out in a decentralized fashion, under the auspices of regional agencies of the Ministry for Ownership Transformation. The Ministry itself has set the decision and procedural criteria and it supervises implementation.

Small and medium-sized companies may be privatized as going concerns and sold at public auction or through invited tenders. Investors are offered concessional bank loans; they may buy the stock on installment or pay for it with bonds issued by privatized companies. As an interim step preceding sale to private investors, the program permits enterprises to enter into management contracts with individuals or with Polish or foreign firms.

The alternate approach involves liquidation carried out in accordance with the legal procedure outlined earlier. This, as it turns out, is the most common approach to the privatization of small-to-medium sized business.

## PRIVATIZATION: PROBLEMS AND PROGRESS

The first eighteen months of democratic rule witnessed the growth of small private businesses. Despite the high priority and popularity of privatization, its implementation has been slow, and large state-owned enterprises continue to dominate the Polish economy.

There is some resistance to change, especially by former "nomenklatura", and by people who, in principle, favor privatization but also fear losing the entitlements promised (though very often not delivered) by the Communist regime. Previously every citizen was entitled to a job, a house, and free medical care. There were special privileges for veterans, holders of military or civilian decorations, heroes of labor, distinguished artists, and so on. To a person of middle age, the market system offers few opportunities, and the loss of entitlements constitutes a real threat. One does not have to be a Communist sympathizer to want to hold on to a position on the Employees' Council or collect a wage without much effort or fear the loss of one's job. There is support for change; indeed, the acceleration of change has proven to be a potent political slogan. But, at the same time, many wish to avoid the hardships of the transition.

The economic, legal, and administrative obstacles to privatization, noted earlier, are serious. Here we shall show what difficulties were encountered along the different routes to privatization and what was done to overcome them.

### *Institution-building*

Perhaps the most striking feature of Poland's Communist heritage is the absence of institutions basic to the functioning of a modern market economy. Some economic activities such as small-scale retail trade appear capable of operating within a rudimentary institutional structure, but larger and more complex undertakings require strong institutional support. This difference in requirements may help explain why privatization of the retail trade has so far outdistanced the privatization of other economic sectors.

Under Communism, the pre-World War II economic institutions disappeared as did the people who knew how to run them. The present commercial code dates to the 1930s; it must be revised to suit the needs of modern business. Commercial and investment bank offices must be opened with trained personnel. New regulatory rules also must be established, and employees must be taught how to apply them. Indeed, institution rebuilding has to start at the enterprise level. The Communist regime imposed rigid bookkeeping standards on enterprises, but concepts of accounting and of auditing fell into desuetude.

Much of the work done on the reconstruction of institutions is invisible to the casual observer with the exception of the reopening of the Warsaw Stock Exchange on 16 April 1991. Symbolically, the Exchange is located in the premises of the former Communist party headquarters. At its first session in over fifty years, the five stocks of the five newly privatized companies were traded. Until such time as the volume of trade builds up, the Exchange is to open for one hour per week. The achievement, as well as its modesty, are to be noted.

### *Privatization Through Public Stock Offering*

The first five companies were privatized through a public stock offering in December 1990 and January 1991. More than 130,000 investors bought stock worth 350 billion zloty (about $35 million) and the stock of the five companies was oversubscribed. One more company was privatized in May 1991; six more were being prepared for privatization in summer 1991 and another twenty or so for winter 1991-92.



The initial five were carefully selected for their current performance and future potential, and the offering price was deliberately set at a low level to ensure its rapid rise on the secondary market, thereby encouraging future investors. Yet, within two months one of the five enterprises was on the verge of bankruptcy and two others were experiencing serious difficulties. The problem was that an adequate valuation of large and medium-sized enterprises was nearly impossible in this period of transition from communism.

In the West, the valuation of an enterprise hinges upon past performance. The price/earnings ratios of similar enterprises with publicly traded stock provide more information on the market price of an enterprise. These valuations tend to be costly and inaccurate, and in Poland their valuations are costlier and less accurate.

The valuation problem is a direct outgrowth of communism, where factor and product price distortions deprived book entry "profits" of any meaning. Moreover, though enterprises kept their books in reasonably good order, the entries do not lend themselves to Western-style profitability calculations. Even if one successfully calculates the appropriate shadow prices and uses them to reconstruct the records, it is not clear whether the results give a reasonable basis for forecasting the future, when the economic environment will be completely different.

Finally, even if an adequate "guesstimate" of future returns is made, there remains the problem of estimating their present value. In economies with well-functioning financial markets there are various indicators that help determine the appropriate discount rate — the "riskless" rate of return on government securities, the private bond rate, and the price/earnings ratio that is "normal" for securities of similar enterprises. In Poland, the only benchmark is given by the discount rate determined by the Bank of Poland; but this rate bears no relation to the real long-term equilibrium price of capital. Calculations of the present value of long-lived projects are extremely sensitive to the rate of discount. Hence, no matter how careful the appraisal of future profitability of an enterprise, the present value calculation is subject to substantial error.

If the process of valuation could be accelerated, the absorptive capacity of the market would set a (modest) maximum to the volume of public stock offering. Even in developed market economies a large stock offering may depress the market. However, the size of an individual issue is invariably small relative to the total volume of traded securities. Moreover, in such economies individuals and institutional investors hold government bonds in their portfolios. When an enterprise is privatized, say in Great Britain, the government can maintain stock market prices by repurchasing its debt. Thus privatization can be looked upon as a portfolio readjustment.

In Poland, as of this writing, only six stocks are traded on the Warsaw Stock Exchange — and none of the companies listed ranks among the largest 500. Only a negligible proportion of the public debt is held outside the banks. There are no institutional investors in the Western sense. Individual savings are held mainly in zloty accounts and hard currency. Their total value approximates 9 billion U.S. dollars. It is unlikely that households would be willing to invest more than a quarter of their savings in stocks. Hence, the investible funds constitute only a small fraction of the estimated $100 billion in equity capital of enterprises to be privatized. In principle, urban and rural privately-owned real estate could serve as an important source of finance. Unfortunately, mortgage lending disappeared under communist rule, and the reconstitution of mortgage banking is held back by the ownership issue. As long as titles to property are not clear, there is no possibility of utilizing property as security against loans.

One way to overcome the financial barrier is through leverage — the government can loan equity purchasers money to buy the shares of privatized enterprises. This approach was used in the case of a meat plant that was sold directly to its employees, almost all of whom bought some shares. But the employees' savings and the individual bank loans obtained by them to purchase the securities covered only 20 percent of the company's value. To pay for the remaining shares, the new private company obtained a loan on preferential terms from the Ministry for Ownership Change whereby the government agreed to an Employee Stock Option Program (ESOP) type structure and acted as a banker. But the government is not generally willing to act as a banker of ESOPs.

Selling enterprises directly to foreign investors remains a possibility. To date only a few companies have been sold to foreign concerns, but numerous additional sales are being negotiated, and the direct sale process is gathering momentum. Foreign investors perceive Poland as a politically and economically unstable country and give it a very low rating in "country risk" terms, while many Poles fear selling out for an unreasonably low price. Nevertheless, both sides appreciate the opportunities for, and the importance of, enticing foreign capital and know-how.

### *Privatization Through Liquidation*

Liquidation, followed by the formation of successor enterprises, is by far the most important form of privatization. Between 1 August 1990 (when the Privatization Law came into force) and the beginning of April 1991, 111 enterprises, employing a total of 46,000 workers, were privatized through liquidation. Most of the liquidated enterprises were small or medium-sized, but two companies (a service company with more than 5,000 employees and a trading company with more than 6,000 employees) were relatively large compared to other enterprises in their respective fields.

In the case of liquidation, a simple valuation process is followed. The assets are either leased, usually with a purchase option, or auctioned. The leasing option is particularly attractive since it obviates the need to mobilize capital for the purchase of assets.

The lessee is almost invariably a corporation which, in accordance with the Privatization Law, includes among its stockholders the majority of the employees of the liquidated enterprise. To reduce the probability of "insider" deals, the Ministry of Ownership Transformation whenever possible insists that at least 20 percent of the stock of the new companies be held by non-employees. Still, the successor companies come close to the worker-ownership model.



### *Privatization of Small Business*

Privatization of the small business sector is less spectacular, but perhaps more important, than that of medium-sized and large enterprises. Small businesses (especially in the retail trade) are in direct contact with consumers and can pressure producers to lower the price and improve the quality of goods.

From a socio-political point of view, private ownership of small business is highly desirable. Sociological studies indicate that more than 90 percent of respondents favor the privatization of crafts, the retail trade, and small-scale industry, and 40 percent of respondents would set up their own business if conditions were favorable. In addition, most respondents with investible savings would prefer setting up their own business over buying stock in privatized companies. After decades of bureaucratic regimentation, Poles want to strike out on their own and sympathize with those who do.

The privatization of small-scale enterprises presents few technical problems. The fixed asset of a typical store is primarily the floor space, whose value depends on the location and the condition of the building. The value of the premises can be determined expeditiously through an auction. Given the uncertainties of the ownership status of real estate, the current practice is to auction off two-year leases, and not the premises.

The privatization of small and medium-sized units has been proceeding apace. By the end of 1990, 70 percent of all retail outlets had been transferred to private ownership. The auction process, in principle, should result in a more rational use of space than under Communist-style planning. The transition, however, is difficult for many Poles. Communist planners skimped on commercial space (Marxian doctrine considered commerce to be "non-productive" and therefore a low-priority activity), hence store leases often fetch high prices at auctions that cannot readily be met by groceries or other types of food stores. Not infrequently, the neighborhood government food store is replaced by a private fashion boutique offering merchandise at prices beyond the reach of all but the well-to-do few. Under the Communist regime the customers knew where to find the store they needed, but usually could not buy what they wanted. Now the merchandise is available if one can find the appropriate store. Luckily, the difficulties of the many are mitigated by a burgeoning street trade in food and household products. At this "lowest" level, laissez-faire brings rapid, visible, and highly welcome results.

## SOME CONCLUSIONS

In market economies enterprises are privatized to free government from a task which it is inherently ill-suited to perform — namely, the management of business ventures. A secondary goal is to improve enterprise performance. Budgetary balance may be positively affected. But in the Western context, privatization is expected to have no more than a marginal effect on the economy. Even if the enterprise in question is as large as British Steel, many larger enterprises are already in private hands.

In Poland, as in other former Eastern Bloc countries, privatization is the carrier of change. An inefficient economy, dominated by ill-motivated, ill-managed, overstaffed public enterprises will be transformed through privatization into an efficient market system. To ease the transition, the State will need to provide the institutional infrastructure, but it will be up to the new owners to make the new system work. Private ownership is counted upon to bring better financial and technical management and better marketing. Private owners are expected to dismiss the redundant employees and motivate the ones who are retained.

Will the private owners be able to make the necessary changes? In the West the task of rationalization is usually undertaken prior to ownership transfer, on the presumption that it is easier for the State than private owners to dismiss workers and carry out other radical changes. The Polish government, in principle, could rationalize the commercialized enterprises prior to their sale. In practice, however, it lacks the necessary human and material resources, so enterprises will be transferred "as is".

Will private enterprise be able to carry out this task? Practically no one in Poland has the necessary managerial experience, while foreigners, even if they were willing to come, would find it hard to operate effectively in an unfamiliar environment. The Mass Privatization scheme hopes to cope with the situation by promoting mixed teams. Yet, after years of work slackness, the imposition of strict discipline on the workers will be difficult. And with rising unemployment the necessary labor force reductions may be impossible. The competitive game might prove to be too difficult to play, and the private owner, in alliance with the workers, may pressure the government for tariff protection or other special favors to insure adequate profits and obviate the need for painful reforms.

We draw such a pessimistic scenario to warn against the attachment of excessively high expectations to privatization. Privatization will put an end to the anomaly of rudderless State enterprises and get government out of the business of doing business. Privatization thus is essential to the restoration of a healthy economy, but it is not a miracle cure. Poland's privately owned industry is bound to improve over the years, especially if the economy is integrated with Europe's. Improvements from privatization, almost certainly, will be gradual and painfully slow. But privatization will break up the existing inter-enterprise connections that kept out potential new competitors, thus welcoming new entrants. New business ventures, unburdened by the past, will most probably prove to be the real carriers of change. Thus "Mass Privatization", by breaking up the old structures, will contribute to the formation of an "even field" on which, if the current laissez-faire policies are maintained, the competitive game will be played.

## NOTES

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