

# STATE OWNED ENTERPRISES AS OBJECT OF TRANSITION AND STRUCTURAL REFORMS IN CEE: THEORETICAL BASIS OF A NECESSARY RETROSPECTIVE ANALYSIS

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## **Abstract:**

*At the beginning of the 9th decade, Central and Eastern European (CEE) countries were in a dilemma of epic proportions. Although the policy option was taken, the problems of transition just appeared for policy makers, scholars, as considerable challenge about the models and the way to be applied. Thus, Central and Eastern European countries became an immense laboratory for testing the theories of transition, as well as a place of political struggle, and results were highly contradictory. After more than two decades after that period, we found a clear dominance of neoclassical models, and an obvious passing – by of relevant points of view supported by the Austrian school. While the neoclassic focused on state's involvement in reforms, establishing new economy institutions, the Austrian school said that not the pace of reform is important but the order of actions and the establishment of property rights itself. For Romania, even if the reason and option of privatization were clear, we can say that unconditioned embrace of the neoclassical model in a developing economy rather than an economy in transition may be an explanation of the inconclusive, painful and often frustrating results of privatization and reform in Romania.*

**Key words:** companies, transition, reforms, privatization, Central and Eastern Europe (CEE)

**JEL classification:** P26, P31

## **INTRODUCTION**

For most Central and Eastern European states, the beginning of the ninth decade made governments face the dilemmas of economic and social transition. Though the political option was taken, in terms of methodology and in relation to the economic policy recommendations, based on a “definite theory of transition”, things were not clear. “However, a rather vague consensus emerged, based on the neoclassical economic theory, according to which two concrete measures would be essential to introduce change: the imposition of structural changes as regards ownership through the privatization of state assets and the liberalization of prices”. From this basic scheme various “transition models” emerged, differing from one another by details of the practical solutions adopted and by the time sequence of events (Dochia, 1999)

For more than one decade, Central and Eastern European countries became an immense laboratory for testing the theories of transition, as well as a place of political struggle, and results were highly contradictory from one country to another, from one method to another and from one stage to another.

The theoretical underpinnings of the economic reform process emerged around several options that tried to answer a series of questions such as:

- First privatization and then the restructuring of companies?
- What is the optimal pace of reforms: gradual or shock therapy?
- Is the initial shock of price liberalization necessary?
- Are budget deficits and dramatic decreases in production inevitable?
- If the privatization of large companies is inevitable, how could this be done so as managers and employees would not inhibit but facilitate that process?

According to Calcagno and others, processes of reform and privatization in Eastern and Central Europe emerged, at least theoretically, from the main debates of the period: the neoclassical position and, respectively, the solutions of the Austrian School. “While neoclassical economists

focus on macroeconomic issues in the process of transition, the Austrian School focuses on microeconomic issues. A part of the on-going debate between neoclassical economists is whether state-owned industries should be restructured before being privatized” (Calcagno, Hefner and Dan, 2006).

### **THE NEOCLASSICAL VIEW: BETWEEN GRADUALISM AND SHOCK THERAPY**

According to the neoclassical theory, in the circumstances of a sufficient number of economic agents and established prices between buyers and sellers (depending on the interests and information they have), competitive markets can exist and fulfil the function of optimal allocation of resources. Thus, in order to achieve the prerequisites mentioned above, from the neoclassical point of view, the process of transition should include the following four stages/reforms: macroeconomic stabilization, liberalization of prices and of private initiative, removal of barriers to trade and foreign investment and the privatization of state enterprises” (Calcagno, Hefner and Dan, 2006).

Starting from this staging, the perspectives on how the privatization process should start and develop shaped into two main options, namely gradualism and shock therapy:

- a number of researchers showed that the gradual method is the key of success in the process of transition in Eastern Europe, that a rapid transition would not be successful but would generate massive unemployment, bankruptcies and social difficulties and would ultimately need the intervention of the state. From this perspective, the development of some appropriate institutional structures, such as tax law, financial intermediaries and capital markets must precede the formation of property rights (Cohen, 1993). In order to avoid the hard effects of accelerated reform, they argued in favour of a certain control of prices, a controlled depreciation of the currency and the gradual restructuring of firms, so that the inherent decrease in production would be progressive and reduce the negative effect on the development of the company and on employees (Bruno, 1994; Blanchard, 1997; Aghion and Blanchard, 1993; Carlin, Van Reenen and Wolfe, 1997).
- the other economists, who argued in favour of rapid transition, accepted the existence of the above-mentioned problems, but maintained that the key to the process is macroeconomic stability, associated with low inflation and unemployment rate, economic development and stable fiscal and monetary policies (Sachs, 1997). The privatization of enterprises is essential for the success of transition, but due to a process called spontaneous privatization, by which managers alienate company assets, the large majority of the population starts to have negative feelings in relation to privatization. Thus, after the turning of enterprises into joint-stock companies, the possibility of such securities transaction should be the first step towards privatization (Sachs, 1992). Though they had an unconditional support for the fast approach, authors warned that it would not automatically lead to an immediate increase in productivity or managerial efficiency, and the next step after the possibility of trading shares should have been the depoliticizing of management (Lipton and Sachs, 1990), the change of business objectives, so as they would no longer have in view meeting politicians’ wishes, but the maximization of profits. Restructuration reduces inefficiency, improves corporate governance and eliminates political control in capital allocation. Therefore restructuring is a critical strategy to remove politicization and increase efficiency, thus opening the way to privatization.

Beyond these positions that concern the rhythm of change implementation, there were voices that questioned whether traditional methods of stabilization adopted in Western Europe might be efficient in economies where state ownership was prevalent, or if the Western European experience might be directly translated in countries of the Eastern Block. Of course, from the neoclassical point of view, transition involved macroeconomic stabilization and the attempt to liberalize internal and external markets before approaching the problem of private property rights,

but theorists and practitioners should be aware that Western European restructuring and privatization models applied in the traditional market economies, in which the rules of the game, institutions and the private sector of economy were already stable, that „models of reform based on the principles of the conventional neoclassical economy probably underestimate the importance of informational problems, including those resulting from the problems of corporate governance; of the social and organizational capital; and of the institutional and legal infrastructure necessary for an efficient market economy” (Stiglitz, 1999).

As a conclusion to the solutions put forward by the advocates of the neoclassical theory, we can say that the main difference between the gradual and the rapid approach in the process of transition was not the order of stages implementation, but the pace in which that process was to be implemented: the gradual approach is sequential, while the "big bang" approach attempts to address problems simultaneously. In fact, both approaches of the neoclassical paradigm required the state to engage carefully, step by step (that is somehow in contradiction with the neoclassical essence of free markets), and the focus was on macroeconomic issues, considering that the market -once organized and regulated, would find the best way to manage transition. Microeconomic issues, such as property (at either corporate or individual level) are secondary and would gradually find their solution.

### **THE AUSTRIAN SCHOOL OF THE PROPERTY RIGHTS AND THE STEPS OF TRANSITION**

In contrast to the supporters of the neoclassical theory, the economists of the Austrian school consider that transformation, irrespective of how it will manifest, can only be fast, but the term "shock therapy" is inappropriate and may generate negative feelings. In their view it was important not to shock, but find those actions that would make economy move forward very fast. Supporting a rapid transformation of former socialist countries into countries with a free-market economy, the advocates of this school (Boettke, 1994.) explained that both transformation processes and speed should be considered, that correct and effective incentives should be found in order to increase the speed of transformation, though cultural and historical features of each state that entered the path of changes should not be ignored.

The perspective of the Austrian school on the process of privatization is opposed to the neoclassical view, emphasizing the fact that the establishment of property rights over state-owned enterprises is essential, being the first step to be followed. Only when property rights have been established, their restructuring and transaction may begin. According to the Austrian school representatives, property rights create:

- a legal environment that provides credibility and confidence that investment is encouraged;
- proper incentives to determine the responsibility of decision makers in relation to the holders of property rights;
- an environment of social experimentation that stimulates progress;
- means for economic calculation, allowing the acquisition and interpretation of market signals on prices, profits and losses that can reasonably guide resource allocation.... "If property rights are set correctly, entrepreneurship will lead to new industries and competition" (Boettke and Leeson, 2003). Contractors involved in the market process will be able to evaluate prices, and create a dynamic market economy, therefore the beginning of transformation with the restructuring of existing industries will only delay this transformation.

Rothbard makes several recommendations to avoid desocialization and stresses that markets can not be planned:

- first, governments should not interfere with free markets.
- secondly subteranean markets should not be illegal.
- the third recommendation is to avoid increasing the money supply.
- finally, taxes should not be increased (Calcagno, Hefner and Dan, 2006).

According to the analysts belonging to the Austrian School, economists and policy makers who adopted the neoclassical position ignored all these recommendations in the transition process policies and it is obvious that Romanian politicians were in favour of the neoclassical position. Policy makers exploited public distrust in the privatization when it applied to an enterprise on which the fate of an individual or a family depends and gradualism and restructuring supervised by government were presented as the only way the state could minimize negative impacts and prevent failures. Thus, the neoclassical approach delays the privatization process and it is likely that it will not lead (in a reasonable time) to the settlement and redistribution of assets needed to create a functioning market.

In conclusion, the Austrian perspective on privatization opposed the neoclassical vision, emphasizing upon the establishment of property rights as a fundamental, primary step. Only when property rights were established, institutions, entrepreneurship, market signals of price expectations, the size of profits, etc., could cooperate for the success of restructuration. Finally, Austrian economists said that planned economic reforms, even if made on behalf of the market economy, remained a form of planned economy (Calcagno, Hefner and Dan, 2006).

What are the results of this analysis on the situation in Romania? According to analysts, one of the initial errors made was not to treat Romania as a developing economy, but as an emerging economy. Drastic changes in law, government structures and access to resources were characteristic of developing countries, and in such a country, resistance to economic change is rapid and, in parallel, a tendency of political power to monopolize economic resources is present. Thus, governments should have the power to implement reforms and economic change, but strong government involvement in these aspects of the economy is likely to delay economic growth (Calcagno, Hefner and Dan, 2006)

According to Boettke, the adoption, by policy makers in Romania, of the neoclassical theory (and methodology) on development explains why Romania (and other former socialist countries) were not treated as developing countries and why reform results are so inconclusive (Boettke, 1994). Seeking a symbiosis between positivism of neoclassical economics, the Keynesian revolution and the realities of a socialist economy, governments ignored the importance of institutional infrastructure, turned down governments' objectives aimed at drawing the rules of a functional economy towards its effective functioning, and diminished the role and importance of understanding the links between capital (microeconomics) and macroeconomics.

## **PRIVATIZATION OF STATE OWNED ENTERPRISES: BRIEF THEORETICAL OVERVIEW**

The theory and practice of privatization has evolved over the last twenty years, both as regards its definition and objectives, and especially in the applicative area, of mechanisms or main corrections resulting from the onset of the trial period.

In the narrow sense, privatization can be defined as the legal transfer of ownership from state to private operators, while broadly explained it includes all measures that contribute to the denationalization of economic activity. It can be argued that this definition may include a situation where in economy there still is a major state-owned sector, but which is governed by market rules and subject to competition and if the state transfers, in various forms of long lease, assets that are used in market conditions. Finally, broadly speaking, privatization includes the creation of new private enterprises that is privatization is identified with the liberalization of economic activities and encouraging private initiative.

Regarded as carefully as possible, as part of the great social and political transformations of the 90s, privatization is at the same time part of economic and social restructuration, to which a series of roles and long or medium-term objectives are attributed (Lavigne, 1999).

- social and political objectives, among which the most important appears to be the creation of a new class of capitalists and entrepreneurs;

- ethical objectives and considerations – return of property to those who owned it in the past and who were dispossessed during the forced nationalization at the beginning of Communist regimes, and the appropriation of employees with parts of the enterprises in which they worked, or the widespread distribution of ownership certificates to the population;
- objectives of efficiency that can even turn into the primary objective and confirm the validity of the privatization decision; improving the management of remaining state owned companies, the acceptance, by all agents, of strong budgetary constraints, competitive pressure, corporate governance rules are valuable consequences, whose performance does not depend on the type of ownership;
- financial objectives, especially when privatization takes place in the capital market, the sale of state-owned packages to major companies;
- objectives of monetary stabilization, channelling cash currency held by the population in the early years of reforms, avoiding unproductive consumption growth or erosion by inflation.

Depending on the country, period or method chosen, one or more objectives prevailed: thus, in the first years of the ninth decade in Hungary, objectives related to financial aspects and stabilization prevailed, deciding that the main privatization method would be the sale; Between 1993-1996, Poland gave priority to the interests of fairness, giving employees and the management of enterprises the right to choose the best way of privatization, and a certain percent of bonus shares, Czechoslovakia (until 1993 and then in different forms, its two successor states) sought to combine social and political judgments with the ethical ones (restitution and distribution of certificates); and Russia adopted political and economic objectives. As far as Romania is concerned, ethical objectives (in which the action of certificates distribution came forward during a first stage) prevailed over the ones relating to efficiency or financial aspects.

## CONCLUSIONS

Extraordinary political changes at the end of 8<sup>th</sup> decade and beginning of the 9<sup>th</sup> decade of last century left few options, methodology and or calendar for reforms able to lead to a functional economy. Transition theory has a vague link with some principles supported by neoclassical economic theory, emphasizing the two key measures to be introduced: structural changes in terms of property – the privatization of state assets and price liberalization measures. Thus, in terms of neoclassic approach, the transition process should include the following stages of reforms: macroeconomic stabilization, price liberalization, encouraging private initiative, foreign trade and investment liberalization and privatization of state enterprises. In contrast to neoclassical theory, supporters of Austrian school believed that transformation, regardless of how it will manifest, can only be fast. In their opinion, it was important do not apply shock to economy but to find actions that would make the economy move very quickly forward and the establishment of property rights is a fundamental, primary step. Only when property rights were established, institutions, entrepreneurship, market signals are real and can ensure the success of restructuring. Privatization as part of the great social and political transformations of the '90s was part of the economic and social restructuring, an objective for each country on medium term. For Romania, it is clear that unconditional adoption of neoclassical models wasn't the best inspired choice.

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