Moving Ahead: Privatization in Poland

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Ten years into Poland's transition to a market economy, privatization has made substantial headway. Privatization is almost complete in some sectors, such as consumer goods and services. In others, for example the banking sector, it is fairly advanced. In still others—especially large, politically sensitive sectors such as public utilities and some portions of heavy industry—it has barely started. A recent report on which this article is based (see box p. 19) analyzes how far privatization has progressed in Poland and the factors impeding further advances.

Parliamentary decisions and government policies are among the factors influencing the pace of privatization. Even today—almost 10 years since the start of the transition—the country's legal and institutional frameworks are less than ideal for rapid and broad privatization. Some barriers hindering privatization are still standing. Many politicians still fail to grasp the importance of privatization for the whole economy and the consequences of its delay.

Nevertheless, strong political pressure to accelerate the overall process has emerged recently because privatization revenues have become crucial for implementing reform of the pension system and other social programs. Therefore, it appears likely that the current government will give high priority to pushing ahead on privatization.

Sound policies get results

The experience of the past 10 years demonstrates the basic soundness of the underlying principle that have guided Polish privatization from the start: to find and choose the best possible investors for the different types of enterprises being privatized. This approach has meant adopting individualized, market-oriented and time-consuming methods of privatization rather than massive and quick privatization schemes. Although this course has yielded positive outcomes for many enterprises, it has had negative implications for others that remained in the public domain longer. Such a case-by-case, tailored approach to privatization takes more time, and Poland's administrative apparatus has been inadequate to quickly transfer many sectors of the economy into private hands. Another downside to gradual privatization is that it offers critics—such as political parties in power that oppose privatization—more time and opportunity to block the process, as the winds of popular opinion shift.

Conscious of these pitfalls, proponents of privatization in Poland made repeated attempts to accelerate the privatization process. One such initiative was the National Investment Fund Program (NIF), a coupon privatization program that was applied to around 10% of public assets. But the Polish experience, as well as that of its neighbors, shows that it is very difficult to reconcile "wholesale" privatization with the intended outcome: good corporate governance.

On the other hand, many features of the Polish privatization experience have been undisputedly positive. For example, the country has adopted appropriate legal regulations requiring relatively high-quality disclosure standards for privatized companies. These have made the country's capital market much more transparent than in other Central European countries and have ensured a relatively healthy and largely privatized banking sector. Other benefits have stemmed from Poland's use of mainly traditional methods of privatization, based on proper institutional rules. While the process may

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have been somewhat slower and more difficult at the start, over time it accelerated and broadened as the participants' experience grew.

Another notable aspect of the Polish experience is that top-down privatization was not the primary factor in creating the new ownership structure of the current economy. Even more important was the explosion of newly funded private firms, which have become the driving force in Poland's dynamic economic growth. At the same time, the systematic contraction of the public sector through liquidations, bankruptcies, asset downsizing and privatization helped create the conditions allowing the new entrants to prosper.

Privatization's results

Indeed, a proper privatization policy can be helpful in establishing successful new enterprises to the extent that privatization frees assets and human resources previously tied up in state enterprises. The two avenues of private sector activity—assets transferred from the public sector and newly established operations—should be regarded as complementary and supportive of each other rather than distinct and unrelated.

In sum, the portions of Poland's economy that have been fully privatized are truly private, in most cases needing neither subsidies nor other help from the state. The restructuring process conducted in these enterprises is advanced. Many of them are considered success stories in terms of their market share or technological prowess. Enterprises that were only partly privatized or merely commercialized, on the other hand, require additional restructuring and still need state support.

Different methods of privatization adopted in Poland created different types of wholly or partially privatized enterprises. Traditional methods of privatization, such as sale to strategic investors (especially foreign investors) or a public share offering, proved to be most successful in terms of completed privatization, reliable corporate governance and good economic performance. Management and/or employee buyouts were a second-best but also quite efficient approach, at least for the first stage of privatization, since they set the stage for subsequent ownership changes.

The outcome of voucher privatization (NIF), on the other hand, has been rather discouraging. The performance of the enterprises following this privatization track has systematically worsened. Commercialized companies still under state ownership also have not performed well and are in critical need of restructuring. Inefficient corporate governance is no doubt a major factor in the weak performance of both these enterprise categories.

Striking differences in investment behavior between privatized and nonprivatized operations stand to have a big impact on Poland's economic future. In the past few years, privatized enterprises have reinvested 10% to 30% of their sales annually. Meanwhile, state-owned commercialized companies, NIF companies and other partly privatized or still state-owned enterprises invested only 1% to 3% of their sales—less than the assets that they amortized. Also on the macro level, the investment rate of the private sector over the past decade has been much higher than in the public sector. Despite these trends, in terms of the value of total investment outlays, the private sector overtook the public sector only in the second half of 1997, when it achieved a 53.4% share. Since then, its share has been growing steadily.

Evolving political environment

The first reform government in power after the political breakthrough of 1989 aimed for quick destatization of the economy and the establishment of sound private ownership structures. Because of budgetary shortages, that administration preferred commercial methods of privatization and wanted to establish new majority owners in the privatized companies. But the popular view of privatization was at odds with this approach. A broad social mistrust of the whole privatization process prevailed at that time. The public expected privatization to compensate it for losses sustained during the communist era. The idea of employee participation—understood as preferential treatment in securing employees' shares of their enterprises as well

Details on the Study

The articles on the privatization experiences of Poland and Hungary contained in this issue of Economic Reform Today *are based on an unpublished study,* Management and Privatization of Residual State Property: The Corporate Governance Implications. The Experiences of the Czech Republic, Hungary, Poland and Slovenia, *completed in April 1999. The study analyzes the various privatization policies and methods introduced in these countries, what has been achieved to date and what impact the different approaches have had on the final results.*

This research project was sponsored by ACE PHARE, the European Union program for promoting economic and democratic reform, and coordinated by Andreja Bohm of the Central and Eastern European Privatization Network in Ljubljana, Slovenia. The final report is expected to be published later in 1999. More information is available from Andreja Bohm at ceepn@siol.net.

as employee influence on the privatization process itself—also had very strong support.

Special interests prevailed

At the same time, influential industrial groups, especially in parts of heavy industry, together with some political parties and trade union leaders effectively lobbied against privatization. Instead of fast privatization and radical restructuring, they were interested in keeping the state-owned sector unchanged and obtaining preferential government treatment for chosen enterprises or sectors. Politicians who worried about losing a large part of their constituency catered to these concerns. That was the political climate in which the government had to launch its privatization program. No wonder that the policy turned out to be an inconsistent compromise between various political demands.

Coparmex

Despite these obstacles, substantial gains were made in the first three years of privatization, which kicked off in 1991. In 1993, the government attempted to introduce a more supportive legal and institutional framework for the transfer of ownership. Political opposition and lack of public support thwarted these efforts. That year saw the launch of the NIF program.

From 1994 to 1996, the new, left-wing government was not in favor of privatization and the process slowed. During that period, lobbies opposing privatization consolidated their power and new initiatives promoting the establishment of state-owned holdings or other capital groups under state control (instead of privatization) gained support. The privatization of the banking sector was stopped. Proposals to exclude major sectors of the economy from privatization for a longer time were promoted.

This tendency slowly reversed course in late 1996 and 1997, driven by personnel changes in the left-wing government and a growing understanding that faster privatization could speed integration with the European Union and also could help facilitate needed structural reforms. Public attitudes toward privatization also began a gradual shift. Direct experience with privatization demonstrated to many the benefits to enterprises, their employees and the economy as a whole. It also led to a more positive attitude toward foreign investment.

A new privatization law introduced in April 1997 again represented a compromise between opposing political forces. For that reason, it failed to provide a satisfying simplification or clarification of the institutional rules governing privatization. Another factor that generated uncertainty and confusion was the August 1997 central government reform, which failed to synchronize associated changes with the privatization law. That kept the privatization process largely frozen during the second half of 1996 and most of 1997.

Privatization timetable

The current right-of-center government, which came to power in late 1997, committed itself to accelerated privatization and to lifting all limits on the sectors to be sold off. In May 1998, it introduced an ambitious privatization timetable through the year 2001 that calls for selling off all enterprises and sectors still under state ownership, including infrastructure sectors. The plan calls for completing privatization for most sectors and starting on the remaining ones by the year 2002. As part of this initiative, the government produced a report estimating the value of all the remaining assets belonging to the state and setting out the public projects that are to be financed by privatization receipts.

Parallel to this program, the Polish government started preparations to privatize the country's telecom system and large banks. These companies and banks were partly privatized in 1998, greatly augmenting the government's budget. On the other hand, the current coalition government failed to overcome opposition party objections to privatization law amendments meant to make the process easier and more effective.

A new opportunity to accelerate the privatization process arose in January 1999 in conjunction with the country's pension reform, which aims to shift from a pay-as-you-go system to private pension funds. Financial support is needed for the first, redistributive pillar of the pension system because a portion of social contributions from the younger generation now will go to the new, second pillar of the pension reform. Meanwhile, the government has to finance the old pay-as-you-go system to serve the current retired population. According to the law, the deficit is to be paid by the proceeds from special treasury bonds that are to be backed by the receipts from privatization. In order to pay back these obligations, privatization of large state enterprises with valuable assets has to proceed smoothly over the next few years. The Polish telecommunication company, gas and oil firm, copper company, Polish airlines, the two largest banks, and several others belong to this group.

For the second pillar of the pension system, several private pension funds were established at the beginning of the year. The pension funds are privately funded, usually by banks and insurance companies that have domestic, foreign or, in most cases, mixed capital. They are supervised by a specially established, independent governmental office that aims to guarantee compliance with all prudential standards. These funds will collect a portion of social contributions and invest them in the capital market. This market is expected to develop very quickly over the next few years, with the steeply rising demand for securities such as enterprise shares and bonds.

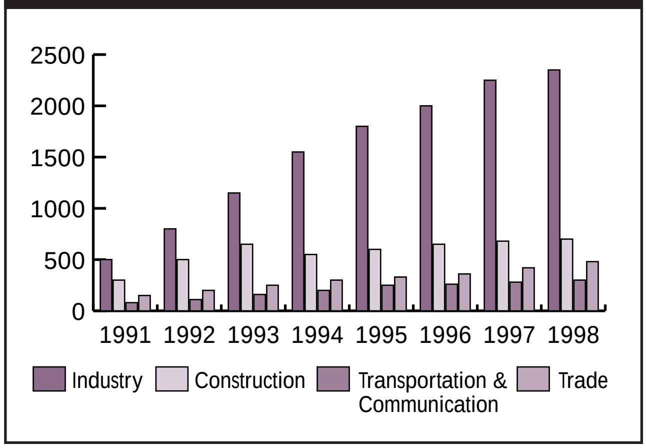
The Scope of privatization

From the start of the privatization process in late 1990 until the end of 1998, 6,129 (72.6%) of a total of 8,441 state-owned enterprises were partly or wholly privatized. If the 1,654 rural enterprises (19.5%) taken over by the Agency of Agriculture Property of the State Treasury for restructuring and privatization under a separate program are excluded, the number of enterprises participating in the privatization process as of end-1998 totaled 4,475. This means that only 53% of those at the starting point were involved.

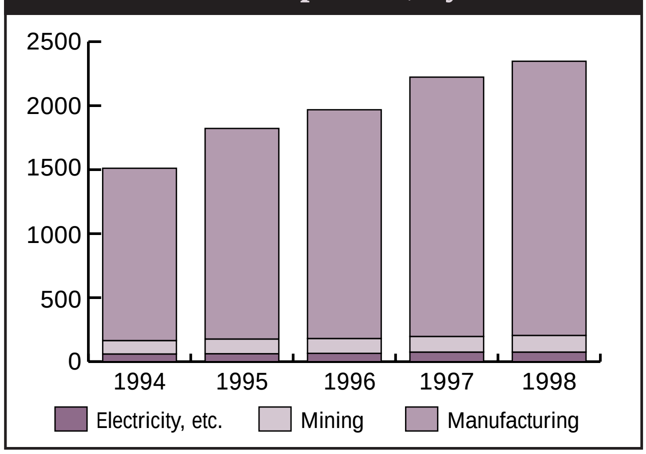
The number of enterprises completely privatized came to 2,454 (29% of the base), while those partially privatized was 2,021 or 23.9% of the base number. (The latter includes 512 companies within the NIF program.)

The number of state-owned enterprises as of end-1998 was 2,906, of which 1,818 conducted full economic activity. In addition, as of December 1997, the authorities had completed bankruptcy procedures for 278 state enterprises and implemented 203 bank conciliation procedures. Debt-equity swaps were adopted for 135 companies in the latter group.

State enterprises in the transformation process, by sector



Industrial enterprises in the transformation process, by branch



The following shows the share of various approaches taken in the overall privatization process:

Commercialization (the preliminary stage before privatization) was introduced in 1,343 large companies. Of this group, 240 large companies have been entirely privatized via capitalization (through IPOs, public tenders or negotiations following public invitations).

Some 512 commercialized companies were designated for the NIF program, which is still underway. Their shares have been transferred to 15 National Investment Funds, and these share certificates were distributed to the public in 1995–96. About 25.7 million Poles, or 96% of the adult population, acquired them.

Privatization through the direct route, sale of assets, was used for medium or small enterprises. The number of operations following this privatization track from 1990 to December 1998 came to 1,551. Among them, 1,515 completed the process, of which 1,021 enterprises were leased to MBOs (management buyouts), 312 were sold for cash, 127 were contributed in kind to new companies, and the remaining were privatized using mixed methods. Direct sale of assets has been the most popular privatization procedure utilized in Poland and by far the quickest to implement.

Around 1,581 state enterprises in weak financial condition have been involved in the so-called “liquidation privatization” program under the state enterprise law. As of December 1988, 699 of them have been liquidated via sale of their assets to outside private owners for cash; less frequently, the assets had been transferred to the employees.

Measured in terms of the number of privatized enterprises and those still being privatized, Poland has made considerable progress. But a large group (some 2,000) of state-owned enterprises—approximately one-fourth of those at the starting point—has never been included in the process. This group consists mainly of small and medium-sized enterprises that were in worse economic condition than the privatized ones, but also includes more than 400 large state companies. Among them are the 50 largest Polish enterprises (the "Giants) belonging to the public sector. Some of them may play the role of "locomotives" of privatization when they come up for sale, while others need serious restructuring.

Private vs. public sector

The pace of privatization in different sectors of the Polish economy has been very uneven. Privatization has gone the furthest in selected branches of manufacturing, construction, trade, and services. Privatization has been almost completely absent in some industrial areas, such as mining, electricity, water and gas supply, and has been very limited in transportation and communications. Graphs 1 and 2 on p. 21 show the proportions of privatization in the main sectors of the economy measured by the number of enterprises that have embarked on or completed the privatization process.

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At the end of 1997, private firms accounted for more than 68% of employment in the whole economy. Private firm employment was 98% in agriculture, 96% in trade or commerce and almost 88% in construction. In industry, the private sector's share of employment amounted to 64% and in transport to 33%. In some kinds of services, such as real estate, it came to almost 70%, and in the financial sector it was equal to 40%. On the other hand, in services such as education (3.5%) or health and social services (6.2%), it played a very small role.

The private sector's contribution to employment in the three main divisions of industry also varied markedly. Whereas it accounted for 74.5% of employment in manufacturing, in mining and quarrying it stood at just 4.5% and in electricity, gas and water supply 5.4%.

Government privatization programs did not provide the main impetus for privatization in every sector. Some sectors, especially trade, services and real estate, are dominated by newly formed domestic and foreign enterprises, though to some extent they benefited from the so-called "small privatization" conducted at the beginning of the transition process. In these areas of economic activity, privatized state assets make up only a small part of the private sector with regard to employment and production.

As of late 1998, the "privatized" sector (i.e., former state-owned enterprises that have completed the privatization process) in all areas of activity employed only 450,000 persons, whereas the entire private nonagricultural sector employed over 6 million persons. At the same time, total employment in the economy, both state and privately owned operations, came to 10 million persons in the nonagricultural sector and 16 million overall. At the outset of the transition process, the private sector provided employment for only 1.78 million persons in nonagricultural activities.

In terms of the number of private enterprises, the picture has also completely changed. The number of private companies and partnerships has grown from some 19,000 at the end of 1989 to around 136,000 in December 1998, including almost 37,000 companies with foreign capital. Over the same period, small private businesses have ballooned from 813,000 to 2.2 million.

Another dramatic transformation is evident from the data on the private sector's share of investment outlays. Private investment is now predominant in the sectors such as trade, services and manufacturing, which have undergone the greatest amount of privatization. In contrast, in sectors that have not been heavily privatized, such as mining and electricity, gas and water supply, public investment still dominates. In areas that were latecomers to privatization and/or market liberalization but where the process is accelerating, such as transport and telecommunications, private investment is showing dynamic growth. In some industries undergoing privatization, the private sector already accounts for the majority of output and employment, even when the bulk of assets still belongs to the public sector.

Illustrating this trend is the financial sector, in which employment and assets remain largely in the public domain while output and investment are "shifting" to the private sector. The relative proportions are even more striking in transport and communications, where the private sector owns only 3.7% of fixed assets but produces 39% of gross value added. It should be noted that in this sector private investment is growing quickly.

The first table on page 29 also provide evidence for the hypothesis that the formerly state-owned assets are not the main basis for private sector development. In addition, they also demonstrate that, while the state still possesses a substantial share of the country's economic assets, these are much less productive than the smaller assets of the private sector. One caveat in drawing this conclusion is that the book value of state-owned assets may differ markedly from their real market value.

In further examining the asset productivity issue, the author compared the sections of the economy with the largest share of state ownership with the most intensively privatized activities. Within manufacturing, the production of oil and coal products registered the highest share of public assets (99.6%), followed by metal production (smelting plants and other heavy metallurgy), with 86.5%. The state also held dominating asset positions in the three non-manufacturing industrial sections—electricity, water and gas supply (99.7%), mining and quarrying (96.9%) and transport, storage and communications (96.3%).

The very high proportions of public sector assets in these few sectors are what skew the state asset average for industry to a high 72.2%. The state's average asset stake for all manufacturing branches, for example, falls much lower (to 45.1%) when the automobile industry (8%), apparel (4.3%), machinery and equipment (22.0%) and food and beverages (22.5%) are factored in. The share of public assets in chemicals (51.9%) is only a few percentage points higher than the average and the corresponding share in the construction industry (36%) and the financial sector (40.8%).

In terms of scope, Poland's privatization program is less advanced than those of some other leading Central European countries, and the share of the private sector in the Polish economy remains uneven. That the privatization process still has some way to go, on the other hand, creates some potentially favorable opportunities for future government policy. For one thing, the country now has much more experience with privatization than at the beginning of the transition process; it can more accurately predict the outcome for certain enterprises depending on which privatization approach is adopted.

The price of waiting

Moreover, Poland can take advantage of much more sophisticated privatization techniques because the capital market and the financial sector are much better developed and professionals involved in privatization are better educated. In addition, Poland's fast-growing economy makes it easier to attract foreign investors—with their capital and know-how—than at the beginning of the decade. That allows Poland to utilize more efficient privatization methods on a larger scale.

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Finally, the country has recognized that the second stage of structural reforms is expensive; privatization revenues could be very useful for supporting the government's special spending plans that these reforms entail. From this point of view, completing the last stage of privatization, that of creating sound and valuable enterprises, may be more beneficial for the country in the future than it would have been in the past.

On the other hand, some important privatization opportunities may have been lost because of delays. For example, the sale of enterprises in the energy or steel sectors, where state ownership still dominates, will be much more difficult and less lucrative than it would have been two or three years ago. The performance of these companies has worsened recently, and they face unfavorable changes in the economic environment. The sugar-processing industry, protected from competition and privatization for many years, is very weak; it needs state help to survive until its privatization slated for later this year. The spirits industry is similarly in poor straits. Because the sector was one of Poland's most renowned national industries, its privatization was not accepted earlier.

Two industries that had been excluded from privatization and competition in the past—coal mining and the Polish Railways—are perhaps the best illustration of the price to be paid for procrastination. They are today the two sectors that produce the largest losses and absorb the largest subsidies. These sectors and others spared from privatization in the past for political reasons include numerous enterprises that could have been successfully privatized earlier but today would be unable to survive in a competitive marketplace. Sooner or later, they will have to be liquidated. That is the cost of avoiding privatization and true restructuring in these sectors.