The Czechoslovak Experience with Privatization
Author(s): Tomáš Ježek
Source: *Journal of International Affairs*, Vol. 50, No. 2, Privatization: Political and Economic Challenges (Winter 1997), pp. 477-488
Published by: Journal of International Affairs Editorial Board
Stable URL: https://www.jstor.org/stable/24357627
Accessed: 09-07-2019 20:44 UTC

The Czechoslovak Experience with Privatization

Tomáš Ježek

In 1991, privatization was launched in Czechoslovakia in a relatively stable macro-economic environment.[1] Unlike a number of other post-communist countries, Czechoslovakia did not have to face a disrupted domestic currency or increasing budget expenditures.[2] What would become the Czech Republic boasted a very small budget deficit, representing 0.6 percent of its Gross Domestic Product (GDP). This compares with deficits of up to 2.2 percent of GDP for the future Slovakia, 2.2 percent for Hungary and 3.8 percent for Poland.[3] This was an important factor which made it much easier for Czech political leaders to effect economic reform in the areas of price liberalization, the devaluation of the Czechoslovak crown (Kčs) and the tax system.

Czechoslovakia was considering several strategies for economic transformation in 1991. Czechoslovak economists and political leaders were relatively familiar with traditional privatization techniques such as direct sales or public tenders, and they quickly concluded that such techniques and programs were not applicable in the Czechoslovak context. When economic transition began in Czechoslovakia in the summer of 1990, Czechoslovak leaders took a unique approach to the problem of privatization and decided to initiate a mass-privatization program, using traditional privatization techniques only marginally.

The mass-privatization scheme became the centerpiece of Czechoslovakia's privatization objectives and represents the main innovation of the privatization process. By distributing vouchers which could be exchanged for shares in state-run companies to the public and funneling them through investment funds, the

---

1. Czechoslovakia split into the Czech Republic and Slovakia on 1 January 1994. This article applies to the Czech privatization only, as Slovak practices began to differ after the split. The strategic considerations behind the Czechoslovak privatization program have been provided by Czech economists exclusively.
2. For example, in 1990 the inflation rate was 56 percent; in 1991 it had fallen to 20 percent, and in 1992 it was 12 percent.
3. Czech National Bank, *Report on Monetary Development in the Czech Republic, January to September 1995* (Fall 1995) p. 75.

Journal of International Affairs, Winter 1997, 50, no. 2.

Czechoslovak government sought to transfer a large number of state-owned firms to the private sector as quickly as possible. In the eyes of the government, this plan also had the advantage of overcoming the problem of private businessmen only having small amounts of savings available for purchases of state assets.

In the first part of this article, I will present in more detail the strategic considerations faced by Czechoslovak leaders in 1991. I will also discuss how the government made the decision to choose a privatization program that put an emphasis on the speed and volume of transfers of state property to the private sector. In the second part, I will present the main characteristics of the Czechoslovak mass privatization program and the successive steps undertaken by the government to create broad public support for the privatizations through a strategy of small-scale privatization and restitution. Finally, I will explain why the government was compelled to introduce traditional public auctions and direct sales simultaneously with the voucher program.

Strategic Considerations for Czechoslovak Privatizations in 1991

At the outset of the economic transition, the Czechoslovak authorities developed an original approach to the privatization of large state-owned enterprises. The primary assumption underlying their approach was that the methods of privatization traditionally implemented in industrialized countries, such as direct sales and public tenders, could play only a marginal role in the Czechoslovak context. Several factors were instrumental in the Czechoslovak authorities' decision to reject traditional privatization techniques and adopt a mass privatization program.

The first significant element behind this skepticism over the applicability of traditional privatization procedures was the environment and climate in which privatization was to be performed. The Czechoslovak privatization was expected to create the prerequisites for restoring the role of market forces in the economy. Czechoslovak leaders believed that market mechanisms had to be created first in order to develop conditions for better performance in state-owned industries. This was radically different from the context in which British privatizations were undertaken in the 1980s.

The British state decided to sell a few large companies to the private sector and based its decision on information produced by an efficient market and stable legal system. Privatization in Great Britain relied on the belief that a former state-owned company would become more profitable once privatized. Enhancing the profitability and efficiency of the company was the only objective of the British privatization program. In Czechoslovakia, the situation was different: in order to create an efficient market, a critical mass of enterprises needed to be privatized in a single move.

In this sense, the profitability and efficiency of Czechoslovak privatized enterprises had a secondary importance in the government's eyes. In practice, it meant that firms were privatized on the basis of their book value rather than at market prices, and through special laws that had the character of governmental decrees, known as *taxis*. Even in the rare cases where it was desirable to sell state assets at market values, prices had to be determined by expert valuations because the market was simply not ready to set prices. Policymakers had no choice but to rely on the price structure inherited from the socialist planned economic system. However, due to the nature of the socialist system, these prices did not reflect the laws of supply and demand. Only after privatization had reinforced the role of private actors in market valuations would the market be able to set prices.

The second element was the ratio between the volume of state property to be privatized and the amount of savings available in Czechoslovakia. There was only a limited amount of domestic savings after 1989, and even this was negligible next to the amount of property owned by the state. Direct sales of state assets would be impossible, therefore, because the public simply could not afford to buy all of the state-owned companies. This problem was particularly acute given the importance of the Czechoslovak state sector compared with that of market economies in other post-communist countries, such as Poland and Hungary. In the mid-1980s, for instance, the public sector share in added value was close to 98 percent in Czechoslovakia, compared with approximately 85 percent in Hungary and 82 percent in Poland.[4] In terms of employment, in 1989 the private sector employed only 16 percent of the work force in the future Czech Republic, while it represented 20 percent of the workforce in Hungary and 47 percent in

[4] B. Milanovic, *Liberalization and Entrepreneurship: Dynamics and Reform in Socialism and Capitalism* (Armonk, NY: M.E. Sharpe, Inc., 1989).

Poland.[5] These differences in the importance of the state in the economy were so enormous that by themselves they would have made privatization in Czechoslovakia a unique process. A mass-privatization program conducted through the distribution of vouchers would take into account this particular problem better than the traditional method of direct sales.

Given the volume of state property, privatization based exclusively on sales of state-owned assets would have been constrained by the rate of savings formation and would therefore have taken decades. This would dangerously extend the transition period to a free-market economy and would unnecessarily prolong the period of economic and political instability. The behavior of managers of state-owned companies waiting for their company's privatization confirmed the conclusion that privatizations in Czechoslovakia could not be based on traditional sales of property as practiced in other countries. Managers of state-owned enterprises typically established private companies under their ownership and siphoned state-owned assets into these companies through various dubious techniques. The industry ministries were still responsible for the health of state-owned enterprises before they were privatized, but many managers were all too willing to subordinate the interests of the state firm to those of the private companies they created.

Thus, the primary purpose of privatization in Czechoslovakia was not to increase the efficiency of particular companies, but to create market structures to encourage private businesses. Fundamentally, this meant that privatization sought to bring about an essential transformation of the role of the government in the economy. The state would leave the business of running enterprises and would take on the responsibility of setting rules for the private sector. Subsequently, a market structure would emerge and enable market forces to be the new economic drivers, particularly in capital markets. Then, and only then, would individual companies be able to measure their performance through market indicators and improve by increasing efficiency. If privatization had been implemented solely through sales of state-owned property, the economic power of the state as the universal owner would have remained virtually unbroken. Instead of owning the country's

[5] World Bank, *Private Sector Development During Transition: The Visegrad Countries, World Bank Discussion Paper, #318* (Washington, DC: World Bank, 1996).

means of production, the state would have the equivalent amount of money. Privatization would merely lead to a change in the structure of assets owned by the state. The economic power of the state would remain unchanged, and it would not be able to effectively exercise its new role in the market economy.

Based on these two strategic considerations—that privatization was the first necessary step toward the creation of market mechanisms and that public savings were negligible compared with the volume of state assets to be privatized—Czechoslovak leaders concluded that privatization in Czechoslovakia had to be conducted through a free distribution of state-owned assets. This was not an easy concept to promote, even though political opposition ended up being weaker than expected. The political opposition was fragmented into many groups, each of which was unable to address public opinion and formulate a clear concept of a positive alternative to the privatization strategies being pursued.

The main opposition had been expected from the "68 boys," the economic reformers of the Prague Spring who have been engaged in an attempt to renew their 25-year-old dream, which was interrupted by Soviet military intervention. Though fragmented, the opposition did raise alarm bells over the disastrous effects that could result from the low level of revenue that would result from a mass privatization program based on the free distribution of assets. They argued that other privatization techniques would substantially increase government revenue, which would make it possible for the state to eliminate its budget deficit. Education, public transportation, environmental protection, and health and medical care were all highly dependent on government expenditures. Both the government that entered power in November 1989 and the parliament were under constant pressure at the beginning of the privatization process to generate more revenue. Nevertheless, policymakers in 1991 deemed it more important to create a free-market structure than to generate revenue. A deficit to GDP ratio of 0.6 percent allowed the Czechoslovak government this flexibility.

Methods of Privatization: Concepts and Reality

Though the government chose to privatize through the free distribution of assets, unpredictable events forced the government to modify this plan. Domestic pressures compelled the government to start the privatization process with restitutions and small-scale privatization, i.e. the privatization of small businesses.

Some Concept Modifications

The first modification arose from the need to restore to its original owners property that had been nationalized under the communist regime. The population had strong expectations that the economic transformation would restore property rights taken from them in the communist nationalizations. Restitution came to be considered the fastest way to privatize state assets. The restitution process was not free of conflict, however. Certain political groups in Czechoslovakia strongly opposed restoring property to some churches, the Jewish community and the German and Austrian communities.

Choosing the date that nationalization actually began was another major conflict in the restitution process. According to Act No. 403 of 1990, property nationalized by the communists after 1959 could be returned to their original owners. However, many political parties and interest groups argued that 1945 was the date that should be used, because this was the year in which most of the confiscations took place under the responsibility of Edvard Beneš, the prime minister of Czechoslovakia at the time. Others thought the date should be 25 February 1948, when the Czechoslovak Communist Party took power. In the end, this position prevailed, and the parliament declared this date as the deadline for restitution claims.

The second modification was the introduction of small-scale privatization. This dealt with the privatization of small businesses such as restaurants and hotels, retail stores and construction businesses. Small-scale privatization was conducted solely through public auctions. It was a very simple method because it transferred pure assets, without any liabilities, to the new owner. The liabilities remained with the state-owned enterprise and were cleared later by the ministry with the proceeds raised during the enterprise's liquidation.

Small-scale privatization was seen as an important step in getting the public involved in the transition, and it received strong attention from all levels of society for more than a year. With every passing week, people in every small town saw the progress achieved by market forces and learned to understand them. The District Privatization Commissions produced an influential group of enthusiasts who became vocal propagators of free market principles and rules.[6] Small-scale privatization, along with the restitution according to Act. No. 403 of 1990 (known as "small restitution") created the basic conditions for small business activities, including the introduction of trade licenses. In this respect, small-scale privatization became a very important prerequisite for the success of large-scale privatization. During a very short period of time, thousands of small business units found their way into the hands of private owners.

The increasing amount of private business activity associated with these policies saw the emergence of a new class of entrepreneurs that would stimulate the dynamic expansion of the private sector. While in 1992 the private sector accounted only for 25 percent of Czech GDP, in mid-1996 estimates show that it represented 75 percent of GDP. Moreover, the number of jobs in the private sector increased from 20,000 in 1989 to 640,000 in 1993. This new dynamism, coupled with the devaluation of the Czechoslovak crown, provide an explanation for the surprisingly low level of unemployment throughout the transition period in Czechoslovakia.[7]

The small-scale privatization program also helped sway corporate management in favor of mass privatization. The speed at which the small-scale privatization was taking place made managers of state enterprises and senior executives in the branch ministries realize that privatization was going to be taken very seriously. While the auctions of the small-scale privatization endangered management positions, the large-scale privatization offered a palatable alternative, transforming formerly state-owned companies into joint-stock companies that made it possible for managers to retain their positions.

---

6 The Czech Republic has 81 districts. The Minister of Privatization appointed a 20-member District Privatization Commission for each district. The Commission was charged with selecting the state-owned assets suitable for small-scale privatization and organizing their public auctions.

7 The dramatic devaluation of the Czechoslovak crown on 1 January, 1991, (Kčs 28 for $1) increased the opportunities for exports and therefore for the maintenance of high employment. This exchange rate has remained stable since then, and the unemployment rate has always been the lowest among Eastern European countries: in 1995, it stood at approximately three percent. (World Bank, 1996) However, some skeptics have noted that this can also be explained by the fact that the Czech Republic has undertaken a limited amount of restructuring operations compared to Poland and Hungary. (*Economist*, 18 November 1995). After an initial decline in GDP growth, explained by cuts in inefficient production, positive GDP growth has been observed since 1994, with current growth standing at 4.8 percent.

The Privatization Process

The mass-privatization program got started in Czechoslovakia at the end of July 1991, when the government published four lists of state-owned companies in an effort to provide a comprehensive view of the companies owned by the state. The large-scale privatization, which depended mainly upon the free distribution of assets, was organized into two massive waves to simplify the process. The first list contained the enterprises that were to be privatized in the first wave, approximately 2,700 companies, and the second list contained those to be privatized in the second wave, an additional 2,000 companies. Every company producing goods for private consumption was ranked in either list one or list two. The third list contained companies that could not be privatized for various reasons and were earmarked for liquidation. Their assets were sold in public auctions. The fourth list was very limited, containing entities that provided public goods, such as museums and schools. The state planned to keep these under its control.

The publication of the first list initiated the privatization process by asking the citizens to submit their competitive privatization projects no later than 31 October 1991. All citizens were invited to submit privatization projects for the companies on the first and second lists, and the management of state-owned firms were obliged to do the same. By the end of the second wave, a total of 28,000 privatization projects were proposed, involving many different methods of privatization, including voucher privatization. Overall, 20 percent of the projects have been approved.

The Voucher Program

Free distribution of state assets in Czechoslovakia was realized through the voucher program. Under this program, every Czechoslovak citizen could buy a voucher at a low price, Kčs35 during the first wave and Kčs50 during the second wave. Each voucher contained 1,000 investment points and entitled its holder to obtain shares in different state-owned companies. In addition, each citizen paid Kčs1,000 as an entrance fee to participate in both waves. Both the fees for the vouchers and the entrance fee were to cover the cost of the privatization process (such as printing vouchers, setting up computers and establishing a retail network able to serve 6 million people in each wave). The sum of Kčs1,035 represented approximately 15 percent of the average monthly wage.

Investment points were not tradable; they were a technical instrument for distributing the total volume of shares offered to the citizens during the first and second waves. Out of the 2,700 firms listed for the first wave, 946 companies worth \$3.5 billion were privatized through the voucher system, and out of the 2,000 earmarked for the second, 861 companies worth \$2.5 billion were privatized with vouchers. Citizens were issued between 30 and 100 (or occasionally more) shares in each wave, with a nominal value of Kčs1,000. The number of shares differed according to the balance of supply and demand in terms of investment points, as determined by the computerized privatization process. The waves proceeded in five and six rounds respectively. Trading on the stock exchange, which started immediately after the initial distribution, has revealed a very different market value for the particular shares.

The government chose the voucher program due to its higher speed and mass character, which was associated with the need to transfer a high volume of state assets to a wide range of the private sector within a reasonable period of time. The voucher privatization scheme was also expected to lay the foundation for the equity market and the stock exchange, the latter being considered one of the key market institutions. The government believed that privatization on a massive scale was the primary condition for an efficient stock market.

The voucher privatization process was organized into bids on the demand side and offers on the supply side. The demand side of the process, from registration of participants to exchange of investment points for shares, was fully computerized, but the supply side entailed an enormous amount of paperwork for the Ministry of Privatization. The original plan, which assumed that both sides would be managed by computers, was not realized. Therefore, the approval process was slower than expected: Five projects were presented on average for one enterprise, and each had to be examined and assessed. Thus, the first wave of privatizations started on 18 May instead of 1 January 1992 as had been planned. This revision of the timetable created some tension in the public, and also entailed a degree of risk. The success of the voucher program depended on people's trust. Any changes in the timetable, no matter how necessary, could create a loss of confidence and endanger the entire process of privatization in the country.

Paradoxically, the delay meant that a larger number of privatization projects could be presented, resulting in a greater diversification of ownership and creating the conditions for restructuring. The original timetable limited the amount of time that projects could be submitted and reserved only ten working days for their processing. If the timetable had not been extended, the state would have been forced to accept almost exclusively privatization projects presented by the management of state-owned enterprises, because only the current management had enough expertise and resources to prepare a project within such a short time.

The main disadvantages posed by projects prepared by current managers was that they often failed to include bold restructuring proposals for the newly privatized firms. Under the communist regime, many non-productive assets were linked to state-owned enterprises, such as schools, kindergartens or swimming pools, and managers were reluctant to liquidate these assets in order to maintain their position. Because there was more time, a large number of privatization projects were presented that proposed further restructuring and competition than could have been expected at the beginning of the process.

Finally, the decision to allow investment funds to enter the voucher privatization program was by far considered the most serious change from the initial program. These funds were introduced in response to the justified criticism that the exclusive participation of individual citizens would create a large number of small shareholders for each emerging joint-stock company, producing an atomized ownership that would never be able to exercise its property rights. Therefore, the investment funds were essential to the privatization process, but their introduction was improvised and failed to be followed by the corresponding legislation. This dangerously reinforced the role of investment funds and entailed certain risks for individual holders of investment vouchers due to the limited role of minority shareholders in the funds.

In both waves, citizens were free to exchange their investment points either directly for shares of a chosen company or put them into an Investment Privatization Fund (IPF), during the so-called zero round. In the first wave, 70 percent of the citizens chose the indirect method of putting their points in IPF's; in the second wave, this figure was 60 percent. In the first wave, 264 IPF's competed for the total supply of shares; in the second wave, the number of IPF's had risen to 353. The IPF's have the legal form of a joint stock company and, after the close of the wave, are obliged to issue their shares to the people who entrusted them with their investment points. Both shares of individual companies and shares of IPF's are traded on the Prague Stock Exchange.

Other Methods of Large-Scale Privatization

The delayed introduction of the voucher privatization program meant that it had to share its place with other methods of privatization such as public auctions and public tenders, direct sales and direct transfers of assets to municipalities. The voucher privatization concept required the transfer of ownership to be organized in two massive waves, with a clearly-established beginning and end, and the other methods quickly adopted the same system. These traditional methods of transferring assets to the private sector could have easily avoided the wave structure and could have been conducted continuously. However, had they done so, they would not have had to meet the deadlines in the voucher schedule, and this could have slowed down the process of transformation.

The fact that the government forced voucher privatization to retreat from becoming the only method of privatization in Czechoslovakia did not alter the process of economic transformation. In the end, approximately 27 percent of state property was privatized through direct sales to individual businessmen, which was more than could have been expected from a mass privatization exclusively conducted through the distribution of vouchers. Proceeds from these sales were generally used to pay debts inherited from the communist period. The voucher privatization embodied the democratic character of the privatization, but the direct sales took into account the second building block of the economic transformation: the right of each citizen to submit privatization bids for any state assets. The mix of states assets given away and sold was determined spontaneously as citizens exercised both these options.

Conclusion: Privatization, Law and Economics

Privatization in the Czech Republic has had impressive results: 60 percent of state-owned assets were distributed free of charge (40 percent through voucher privatization and 20 percent through free transfers to municipalities), 30 percent were sold, and only 10 percent have yet to be sold. In general, the proceeds from the sales have been used to clear debts left over from the communist regime. These debts can be classified into three categories: government debt, debts of state-owned companies, and an even broader category of debt, the damage inflicted on the environment. In addition, the proceeds from privatization have been used to fund the construction of an oil pipeline connecting the Czech Republic to a German pipeline, thus ending the Czech Republic's dependency on Russian oil supply. The economy truly has been privatized: 75 percent of GDP is currently produced by the private sector.

One of the greatest lessons of the privatization in Czechoslovakia is the indispensability of a consistent cooperation between law and economics. For many years, both disciplines have operated in separate spheres in Czechoslovakia, a bad situation that is particularly dangerous for privatization. The privatization process is a major legal transformation with dramatic economic consequences, yet this separation means that lawyers do not understand economic processes, and economists have little regard for the law. This disjunction is embodied by the conflict between special laws or decrees, such as the Act on Large-Scale Privatization, and the general codes, such as the Commercial Code. If state-owned assets had been privatized in accordance with the Commercial Code, as happened in most developed market economies such as Great Britain, privatization would have never been possible, because Czechoslovaks were not merely dealing with sales of companies to private businesses, but were trying to change the overall economic structure of the country.

This explains the need for a special act that could take into account the particularities of the Czechoslovak economy. Privatization sought not only to transfer state assets to the private sector, but also to create the conditions to inaugurate commercial relations between clearly defined entities. An ongoing challenge is to identify when the special laws or decrees lose their validity and the Commercial Code can begin to apply to all economic activities, including privatization. If the Commercial Code comes into force too early, it might endanger the entire process. This has been one of the most difficult aspects for the population to understand, and will continue to be a major challenge in the years ahead.