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Privatisation in Transition – The Polish Way

*The Evolutionary approach vs.
The Washington consensus approach*

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Abstract

The focus of this study is on the privatisation process in a state of transition. This study set out to distinguish the essential factors which explain and promote the emergence of a dominant private sector. From that, two different approaches to privatisation are examined and analysed; the Washington consensus and the Evolutionary approach. The Washington consensus emphasises on the speed of the privatisation process, while the Evolutionary approach advocates for the organic development of the private sector by implementing an institutional setting favourable for private economic activity. Thus, a question emerges in the development of the private sector: What is the relative effectiveness of, on the one hand, fostering an appropriate market environment and, on the other, implementing an effective privatisation program?

The comparison of the two approaches is elucidated in the Polish privatisation process. Initially, Poland adapted the Washington consensus approach. Following the focus on speed, efforts were made to introduce a mass privatisation program (MPP). However, due to informal constraint- the lack of knowledge of what privatisation and private activity implied- and the formal constraints- i.e. the macroeconomic situation and the subsequent stabilisation and liberalisation program, the Washington consensus failed to implement rapid ownership transformation. Rather, the Polish privatisation process was characterised by the Evolutionary approach. In this context, although the privatisation ‘from above’- promoted by the Washington consensus- was a general disappointment, the indirect privatisation in Poland- i.e. IPO sales- was found to be a surprising success generating substantial revenues for the state.

However, the main findings of this study show evidence that the successful development of the Polish private sector is a result from the favourable market environment established in the Polish economy- macroeconomic stability, hard budget constraint, competitive markets and property rights. Furthermore, this study concludes that the extraordinary growth experimented by the private sector share of GDP is due to the emergence of the *de novo* firms, which generates efficiency and welfare gains to the Polish economy. This is evidenced through the empirical studies presented in this study and through the extraordinary GDP per capita development experienced during the studied period.

Keywords; Privatisation; Private sector development; de novo firms; Transition; Poland

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Abbreviation and Acronyms

de novo firms- newly created firms

FDI- Foreign Direct Investment

GDP- Gross Domestic Product

IFI- International Financial Institutions

IMF- International Monetary Fund

IPO- Initial public offering

MPP- Mass Privatisation Program

NIF- National Investment Funds

PA- Principal Agent

SOE- State Owned Enterprise

USD- US dollar

WSE- Warsaw Stock Exchange

1. Introduction

The strategy on which privatisation methods are based has been explored as a main focus point throughout the transition literature in recent years (see Havrylyshyn and McGettigan, 1999; Megginson and Netter, 2001; Aghion and Blanchard, 1996; Jelic et al., 2003). From that, a need to present a new set of strategies became apparent as the East and Central European experiences differentiated substantially from the privatisation process in the developed world (Vickers and Yarrow, 1988; Estrin, 1994).

Although the countries that embarked on the privatisation process were highly different in their economic structures, they shared three common constraints; the lack of national savings, insecure property rights and non operational capital markets (Estrin, 1994). As a consequence, the subsequent privatisation methods were design to circumvent these constraints. In addition, the main concern of the economic advisers and policy makers in the transition countries were on how to privatise the state owned enterprises (SOEs) and effectuate a swift ownership transformation (Lipton and Sachs, 1990). This approach is defined as privatisation ‘from above’ by this study. The ideas of this view are derived from the fundamental faith on the market and the belief that by instigating necessary reforms (stabilisation, liberalisation and privatisation- i.e. the ‘trinity’ of reforms see Roland, 1994) the natural emergence of the market will appear. The collected name of this approach is the Washington consensus. Initially intended for the liberalisation process in South America, this document had great impact on the transition process in general and the privatisation process particularly in East and Central Europe, influencing both policy makers and the international financial institutions (IFIs) in designing the privatisation program (see Williamson, 1990).

As the privatisation programs progressed during the 1990s, a growing discomfort with the Washington consensus- approach was aired by several economists, and a new approach concerning the privatisation process in the transition countries were developed; the Evolutionary approach (Roland, 2001; Kornai, 1990; Winiecki, 2000; Poznanski, 1992).The privatisation ‘from above’ had not generated the satisfying emergence of a strong private sector although this was initially envisaged by the aforementioned economists. This was due to the fact that privatisation contracts were won to a large extent by people close to the former communist regime; therefore inducing the continuation of the inefficient allocation of resources and ultimately the slow progress of the economy. As a consequence- and in

response to the growing discomfort- the Evolutionary approach advocated for the introduction of market environment reforms favouring the promotion of the private sector development (see Winiecki, 2000 and Kornai, 1990).

1.2 Purpose

This study will undertake a comparative study of the Washington consensus- and the Evolutionary-approach. This comparison is exemplified by the Polish privatisation process. Poland displays three distinctive attributes that makes it an interesting research topic. Firstly, the Polish economy had begun its reform process during the first half of the 1980s. These economic reforms liberalised various sectors in the Polish economy and granted more power to the worker councils.¹ Secondly, Poland was one of the first countries to embark on the transition process of the East and Central European countries, and became a member of the European Union in 2004. As a consequence, both the time that has elapsed since transition was initiated, and the relative success Poland experienced when it was admitted to the EU, implies that this process has been highly successful. In this process, the transformation of the state owned enterprises (SOE) into private firms has played a pivotal role. Consequently, the significance of the privatisation process in Poland has been important but, to a certain extent, neglected in the economic research (see Baltowski and Mickiewicz (2000); Slay (2000) and Winiecki (2000) for a recapitulation of the Polish privatisation process). Thirdly, the mass privatisation program was discussed in the Polish privatisation program (see Kruczalak-Jankowska and Kruczalak, 2003). However, as the overall transition process faced augmenting opposition to further reform, the *ex ante* privatisation program- i.e. the Washington consensus-approach- evolved (*ex post*) into an Evolutionary-approach.

Consequently, the purpose of this study is to analyse and assess the relative success of the two privatisations approaches utilising the theoretical tools presented by the Washington consensus and the Evolutionary-approach. From that, the research question that this study aims to answer was first posed- but never answered- by Havrylyshyn and McGettigan (1999:29):

¹ Workers councils are an assembly of workers in the SOE management. As opposed to trade unions, workers councils hold an actual control over the firm, rather than simply negotiate.

- In the development of the private sector, what is the relative effectiveness of, on the one hand, fostering an appropriate market environment and, on the other, implementing an effective privatisation program?

The overall effect generated by the privatisation program in Poland is questioned and will be illustrated. Three theoretical aims of privatisation will be presented in 2.1 (9). These aims will be used in the conclusion to further illustrate the privatisation development in Poland. Moreover, the economic outcome derived from the privatisation process will be evaluated by examining the progress of the share of private sector to GDP and the development in GDP per capita.

The period of focus for this study is 1989 to 2004. The rationale for the selected timeframe is straightforward as in 1989 the Polish transition program was designed and in 2004 Poland joined the European Union. Moreover, fifteen years is an appropriate period of time to study the initial effects of privatisation on the economy, as this allows for extensive new data on the privatisation process to be available and accurate.

1.3 Delimitations

The subject of privatisation is vast. Therefore, it is beyond the scope of this study to highlight each important aspect of privatisation and particularly the production aspect. As a consequence, the theoretical arguments about the enhanced production derived from private ownership presented in 2.1 are assumed implicit throughout this study. In addition, as this study aims to compare and assess the relative efficiency of the two approaches by employing a qualitative approach, a quantitative approach is left to future research on this topic. Although the PA- problem is discussed in 2.1 to give the rationale behind privatisation, it is beyond the scope of this study to elaborate it further in the empirical section.

This study is articulated by first contextualizing in Chapter Two the main subjects related to privatisation; the PA-problem and the welfare economic analysis. This, in order to set out a general description of the economic realities faced by the transition countries, to facilitate an understanding of the context in which the countries undertook their privatisation programs. From that, the study proceeds with an introduction of the two privatisation approaches utilised in Poland; the Washington consensus- and the Evolutionary approach.

In Chapter Three, the first section outlines a brief description of the Polish initial conditions. Subsequently a thorough description and analysis of the Polish stabilisation and liberalisation program is presented. Thereafter, the privatisation ‘from above’- the Washington consensus-approach- and ‘from below –the Evolutionary approach- are analysed and discussed. Chapter Four concludes and evaluates the outcome of the privatisation process on the Polish economy.

2. Theoretical Framework

This chapter contains the theory and rationale aiming to justify why privatisation is important and its expected effects on the economy. Furthermore, two lines of thoughts are outlined- The Evolutionary approach and the Washington consensus approach- aiming to present ideas on how to best create a dominant private sector in the transition countries.

2.1 Privatisation Theory

The main apparent reason for privatisation within the literature is that private owners make more efficient use of the firm's resources than a state ownership. The efficiency gains are derived from the fact that private owners are profit maximisers and will, therefore, allocate their scarce resources as effective as possible. To the contrary, the state owned enterprises (SOEs) face soft budget constraint and lack an appropriate incentive structure, thus lowering their general incentives for an effective resource allocation (Alchian and Demsetz 1973: 22). Consequently, the theory of privatisation focuses on two mutual reinforcing issues; firstly the principal-agent (PA) problem that highlights the different incentive structures between state- and private ownership and, secondly, the production gains that private ownership engenders. This section starts by elaborating the PA- problem of state ownership in order to provide with an explanation on how these problems are solved by a private ownership. This enables the later discussion of the production gains derived from privatisation.

The essence of the PA-problem is predominantly based on the difficulties of creating of an incentive structure so that the objectives of the principal (the owner) and the agent (a manager) merge. Furthermore, the second objective is to create an environment where the information between the principal and the agent is symmetric (Vickers and Yarrow 1988: 7). Regarding the state ownership, the theory argues that this ownership structure accentuates rather than attenuates these two problems.² The logic behind the first objective is that the manager (the agent) lacks the proper incentives to manage the firm, and that the government (the principal) does not have sufficient means to collect the necessary information about the production capacity of the SOE. According to Boycko et al. (1996: 309) and Vickers and Yarrow (1988: 30), the politicians who give the orders to the firm managers are not concerned by the economic efficiency aspects of the production, but focus instead on maximizing the

² see Estrin, 1994 and Kornai, 1990 for an in-depth discussion

number of votes. As a consequence, the firm manager will not be assessed solely on the economic performance of the company, but on a set of multiple objectives determined by the politicians.

Regarding the second objective, the state pays a high cost to monitor the efforts made by the manager (the agent). The manager has better knowledge about the capacity of the enterprise than the politicians have. As a result, asymmetric information prevails in the SOE. Consequently, these two effects- together with low incentives to increase his efforts- make the manager shirk and use the firm's resources inefficiently (Vickers and Yarrow, 1988: 8-9).

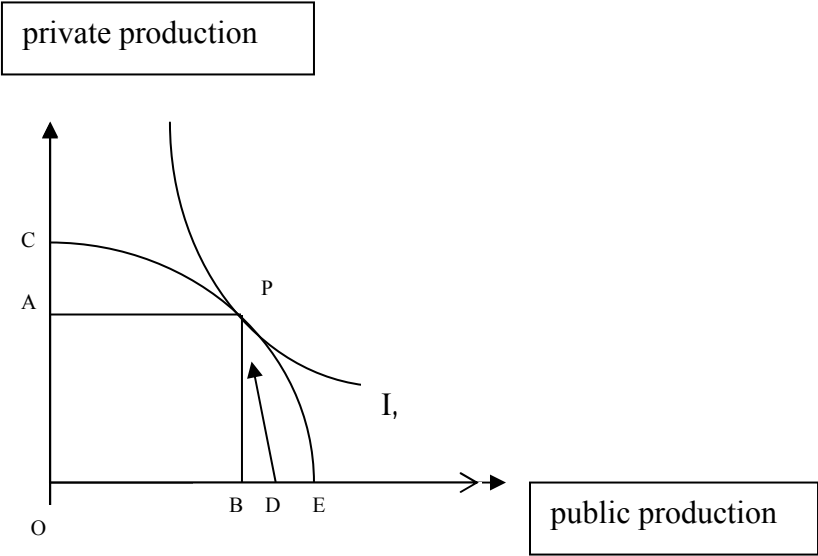
The answer to state ownership then becomes private ownership. A private firm encapsulates the conditions for an efficiently run enterprise. The advantage of private ownership is that it gives the owner exclusive property rights. A bundle of exclusive property right implies the right to determine its use, the right to the earnings of the resource and the right to dispose the resource (Lipton and Sachs, 1990: 303). As a result, the owner reaps the entire risk that the operations of a firm yield, but the owner also obtains the potential revenues that subsequent property rights could generate. Consequently, the private owner has strong incentives to reduce cost and operate the firm efficiently (Shleifer, 1998: 137).

Private ownership resolves the first PA-problem concerning asymmetric information via the creation of a governance mechanism that ensures the manager's profit maximisation behaviour by constructing a strong incentive structure (Estrin, 1994: 14). This is exemplified in the case of tying remuneration to the profit of the firm. In a plan economy, this would be unthinkable since the SOEs are not driven by profit incentives. In addition, the asymmetric information is also resolved through a shareholder-ownership, where information about the firm is disclosed through various forms, thus facilitating the control of the agent. Concerning the case of listed firms, the shareholders (the principals) have at their disposal the means to use the 'exit option'. Additionally, information about the performance of the firm is often disclosed publicly, further reducing the cost of monitoring. Consequently, the agent has an additional incentive to be as effective as possible when managing the firm, as he is held responsible before the shareholders.

In addition to the PA differences between a privately owned enterprise and the SOEs, the welfare economic analysis of different ownership structures gives an additional insight on the

privatisation concept. Referring back to the previous passage where it was stated that private ownership is synonymous with profit maximisation, Schüsselbauer (1999: 67) argues that private ownership will yield an efficient production of goods and the internalisation of costs. Regarding the efficiency gains issued from privatisation, this can be illustrated by figure 1, which describes the optimal supply of public goods.

Figure 1. Static Efficiency Gains through Privatisation



Source: Schüsselbauer (1999: 68)

Line CE allows all possible combinations that are Pareto-optimal. The utility curve I is derived from the preference structure of the households. Point P illustrates the optimal combination of private and state production. At point P, the marginal rate of transformation (MRT, production) equals the marginal rate of substitution (MRS, households). Point D represents in this study a hypothetical starting point prior to privatisation in a transition economy. This point is assumed to be non Pareto-optimal due to inefficiencies that are assumed to exist in a socialist economy, i.e. excess amount of labour and soft budget constraint. At starting point D, the production in a transition economy is characterised by a suboptimal supply of goods due to the inherent lack of being a profit maximising enterprise. Following privatisation, private ownership is reinforced and the production of the goods becomes more efficient. This is illustrated by the move towards point P in figure 1. The overall inefficiencies are reduced through the internalisation of the costs. At the Pareto-optimal point P, the state (public) production has decreased from OD to OB and the private production has increased to OA. This static analysis of privatisation reinforces the theoretical

belief that private ownership achieves - better than state ownership- efficient production in an environment of scarce production resources (Schüsselbauer, 1999: 68).

Following the previous discussions of the principal agent problem and the economic welfare analysis, three clear aims of privatisation emerge. Firstly, the complete separation of the former SOEs from state control is of great importance as it implies the hardening of the firm's budget constraint and the emergence of a strong private sector. The second objective is the creation of enterprises that use their scarce resources efficiently and possess sufficient incentives to do it accordingly. Pictured in the transition context, this is of particular significance as these economies are characterised by limited resources. From that, the productivity aspect- the internalisation of the cost of production- becomes increasingly important due to the increasing competition in East and Central Europe. In addition, a third and final aim of transition lies in the expected revenues derived from privatisation, which were of utter importance for the continuous transition process.

2.2 From Plan to Market -Transition in East and Central Europe

The major economic challenges faced by the transition countries at the onset of transition were manifested growing macroeconomic imbalances and hyperinflation. Campos and Coricelli (2002: 802), note that “output fell in every single country [in transition], with no exception [...]”, making the emerging post-transition picture rather dismal. The deep decline in the first year of transition derives from the fact that neither the plan nor the market was in play, thus creating deep economic recession rather than economic growth (Kolodko, 1999: 239).

Hyperinflation attained disturbingly high levels in East and Central Europe in general, and in Russia in particular where inflation reached levels of over 1000 per cent (Gros and Steinherr, 2004: 84). Moreover, according to Fischer et al (1996: 59) high levels of inflation were found to be negatively correlated with economic growth. Macroeconomic stabilisation thus became of prime importance for the majority of the transition countries in the initial stages of transition.

The transition process was not set out to be a smooth process. In fact, several obstacles that the countries faced initially would reappear along the path of transition. From the onset of

transition, privatisation played a pivotal role in the creation of a market economy. The context in which privatisation was to take place differentiated substantially from recent development experiences. The private sector that would emerge from the transition process was thought to depend to a larger extent on the privatisations programs rather than the economic environment in which they operated- i.e. the Washington consensus-approach. Now ten years on, an additional view has emerged, which sees the evolutionary development of a strong private sector as more advantageous than a state controlled privatisation programs; i.e. the Evolutionary approach.

2.3 The Evolutionary Approach vs. the Washington Consensus

The Evolutionary approach rely on the notion that in order to create a strong and stable private sector, privatisation is of great significant importance but not as significant as the creation of proper institutions and hard budget constraints. In the transition countries, the economies had to adjust to a new set of conditions predetermined by the market economy. These new ‘rules of the game’ had to be implemented in accordance with both the formal- and informal norms existing in the society. Thus, in order to achieve the most effective results of reform, the programs ought to be set up so that the new rules of the game are in conformity with existing norms. In addition, the supporters of market environment approaches do recognise liberalisation, stabilisation and privatisation as the golden trinity in the transition process, but argue that these reforms should be implemented gradually.³

Concerning the Washington consensus-approach, its emphasis was placed on rapid market reforms- liberalisation, stabilisation and privatisation. As the market in the transition countries is extremely inefficient, the reforms envisaged substantial efficiency gains (Roland, 2001: 33). It was a common belief among the Washington consensus supporters that the transition countries economic inefficiencies and bottlenecks could be treated with similar economic tools as in the industrialised countries- i.e. liberalisation, stabilisation and privatisation.⁴ The process of implementing these reforms ought to be swift because a partial reform will only create constituencies that will oppose further reform, thus the ‘window of opportunity’ must be captured as swiftly as possible according to the supporters of the Washington consensus.⁵

³ For the evolutionary approach supporters see: Kornai (2000); Roland (2001); Kolodko (1999)

⁴ NB: the exclusion of institutional approach.

⁵ For supporters of the Washington consensus approach see Sachs and Lipton (1990); Williamson (1990);

The discussion about the two approaches results in two different paths in the creation of an economy which is dominated by the private sector. While the Evolutionary-approach emphasise on the market environment, the Washington consensus approach focus on various privatisation methods- to reach the mutual objective of a dominant private sector. Before embarking on the chosen privatisation approach, the transition countries need to analyse the timing and sequencing of the reforms, which plays an important role in determining which privatisation path a country should embark on.

2.3.1 Initial Conditions, Timing and Sequence

A comparative study of the transition countries requires a examination of the highly different initial conditions that represent each transition country. The economic structure of the country in question affects the analysis of properly determining which of the two approaches is the most apt to decide on. Evaluating the whole economic structure is beyond the scope of this study. Instead, focus will be on three distinctive factors found to be of major significance for the future development of the privatisation process; the share of private sector in 1989, prior transitional efforts and macroeconomic balances.

The share of the private market in 1989 symbolises the efforts made in creating a freer market structure preceding the fall of communism. The causality between the former factor and *prior market reform efforts* is evident. However, this study chooses to add the former factor due to the following reason. In analysing the history of the East and Central European countries, it becomes evident that many of these countries enacted market reform at different stages history. In addition, the focus was on different sectors (e.g. industry, agriculture and trade liberalisation). As a result, these reforms created a diversified outcome concerning private ownership in the East and Central countries. The reforms may not have influenced the total share of the private sector but rather the formal and informal norms of the society, important elements in the overall privatisation process

The last factor is *macroeconomic imbalances*. From the 1970s to the fall of communism in the early 1990s, several countries in East and Central Europe experienced a deteriorating economic stability. According to Estrin (1994: 8) the decline in economic growth had effects on the personal consumption in East and Central Europe. This phenomenon was not recognised by the governments in these countries which, in addition, enjoyed easy access to

credits during the 1970s. When access to cheap capital became more stringent in the late 1970s, the governments could either instigate the necessary investments in the economy and restore their international reputation, or let the foreign debt accumulate. As the interest rate increased, countries failing to repay their debt, allowing continued wage growth through monetary emission, entered transition with unhealthy macroeconomic balances. As a contrast, countries which repaid their debt- at the expense of a sluggish economic growth in the 1980s- commenced transition with a relatively stronger macroeconomic outlook. Consequently, these three factors played a significant role in determining the expected success of the transition process in general and, as result, the privatisation program in particular.

Concerning the timing and sequencing of privatisation, the questions to be answered have revolved around the two approaches discussed above (see 2.3: 13). From the Evolutionary-approach, there was a concern questioning the presence of a sequence in the privatisation process. The question posed by the Washington consensus approach referred to determining if a country should privatise before or after restructuring of the SOEs (Roland, 1994: 1158). The problem of mutual concern appears to be political constraint. Roland (1994: 1161) illustrates the theoretical framework regarding the political constraint problem in privatisation as follows. The *ex ante* constraints are the possibility that the reforms would be blocked. As a result, it is important to take into consideration the future effects engendered by privatisation and how these effects are perceived by the population (i.e. the voters). The *ex post* constraints consider the eventual backlash or reversal that a privatisation program might generate. In a privatisation program where privatisation is perceived as egalitarian but results in a concentration of ownership, there is always a danger of reversal through the ousting of the government. Both the *ex ante* and *ex post* constraints were common in the transition process. Governments were voted off and transition programs encountered harsh opposition from pressure groups in the early stages of transition. The picture that emerges is one who is characterised by both political and economic uncertainty. North (1990: 36-45) argues that under such circumstances informal networks grow stronger and play an important role by reducing the high transaction cost, e.g. access to credit and registration of new firms. Two different answers are given in order to circumvent these uncertainties and work on how to create a dominant private sector. This study therefore focuses on the answers suggested by the Washington consensus- and the Evolutionary- approach.

2.3.2 The Evolutionary-approach

Table 2.3.1

Allocative Change	
<i>Views on Markets and Liberalisation</i>	Accentuate the importance of an institutional infrastructure, i.e. a well functioning legal framework and proper law enforcement.
<i>Attitudes towards SOEs</i>	Support the evolutionary development of a private sector while downsizing the state sector.
Governance Change	
<i>Privatisation</i>	Emphasis on the evolutionary development of the private sector. However, if sales of SOEs, it should be to outsiders in order to achieve efficient ownership structures from the start.
Reform Strategy	
<i>Focus of reform</i>	Create an institutional setting of markets that encourages private entrepreneurship.
<i>Partial reforms</i>	Importance is placed on sequencing, which can create momentum (or stalement).
<i>Views on initial conditions</i>	In order to prevent economic decline, make use of existing institutions.

Source: Roland (2001: 33-34)

The Evolutionary approach (or the gradual approach) envisions creating a strong and dynamic private sector through the establishment of appropriate market conditions that will accentuate the development of a private sector (see table 2.3.1). The supporters of this view give emphasis to the transformation of economic and social systems within a society, which could either stop or create momentum for the reform process. Therefore, the transition process should focus on the creation of institutional underpinnings of the market and encourage entrepreneurial entry over privatisation of SOEs (Table 2.3.1). As a consequence, laws and regulation needs to be ratified in order to create satisfactory conditions for the market. However, after almost 45 years of plan economy, the informal norms in the society need to be altered in order to accentuate the success of the formal norms. Kornai (1990: 54) explains that the “embourgeoisement is a lengthy historical process [...]”, which implies that the informal norms will take some time to alter. From that, one could note that the institutional School of thought highlights the importance of path dependence, lending further evidence to the significance of the initial conditions prior to transition.⁶

⁶ See North (1990) for an exhaustive background on institutional change and path dependence.

Consequently, highly different initial conditions between countries in transition will result in varying designs when it comes to create a dynamic private sector and extract effectively its outcome.

To the Evolutionary approach, the speed of reform is not vital to the overall transition process. Rather, the emphasis is on organic development of the private sector. This influences the view on how the ownership transformation should proceed. According to the Evolutionary approach, the private sector development must coincide with the emergence of private entrepreneurs and a strong middle class. The belief is that these two groups are pivotal to the long term goal of economic sustainability and democracy (Roland, 2001: 36; Kornai, 1990: 56).

Sequencing of reform complementarities is important to this approach. Used correctly, it will create momentum for further reforms, thus overcoming the problem of stalemate. Qian et al. (1999: 1093) argues that the case of gradual implementation of reforms is most favourable during times of distinctive uncertainty. Its reason is that the Evolutionary approach is able to reverse reform that is not proving to work as initially intended. As a result, the reversibility aspect of reform is important for the flexibility of the reforms but it may also create externalities. These externalities could mainly appear through vote maximising politicians, who assess the success of the reform through the popular support for the former rather than the economic efficiency gains generated by the reform. Therefore, an imminence of the political constraint can be expected where transition is influenced by the evolutionary School of thought.

Following the discussion, one major question follows; how will a transition country create a market environment that induces the emergence of a strong and dominant private sector? The literature (Havrylyshyn and McGettigan, 1999: 29-32 and Kornai, 1990) identifies four key aspects for the development of the private sector as particularly important; macroeconomic stability, hard budget constraint, competitive markets and exclusive property rights. However, it is important to stress that although the Evolutionary approach accentuates the importance of the market environment, this approach does not exclude various privatisation methods in order to create a strong private sector. It is important to keep this in consideration when reading 2.3.3, which exclusively focuses on the market environment conditions.

2.3.3 Market environment

Returning back to the discussion in 2.3 (13), *macroeconomic stability* in general and inflation in particular were found to be negatively correlated with the economic development in the transition countries (Fischer, 1996: 59). This fact is also highlighted in the literature review by Havrylyshyn and McGettigan (1999: 29-30) and by Kornai (1990:102; 2000: 20). The main ideas put forward in these papers concern the uncertainty that macroeconomic instability creates. This instability, which often originates from high inflation, shortens the business decisions horizons. From that, Havrylyshyn and McGettigan (1999: 20) argue that high inflation is followed by high nominal interest rates, which result in higher cost on private investment and render private sector borrowing costly, thus limiting the prospects of the emergence of private entrepreneurs. The externalities from inflation are numerous and these negative characteristics further reinforce the high level of inflation. From that, the expectation of inflation becomes self fulfilling, the economic agents on the market expect a certain inflation rate and set their demand accordingly (Kornai, 1990: 106). This is evidenced by the increasing wage demand that follows from transition in general and privatisation in particular. Consequently, the expectations can only be altered through an effective stabilisation policy by the government.

Furthermore, the complications from inflation are, according to the Evolutionary approach, vital to avoid, i.e. the atrophy of the population's savings and the reduction of their purchasing power. Since the development of a strong middle class is prerequisite for a prosperous private sector, lowering the future wage demands and inflation expectations were of utter importance to the transition country wishing to pursue a fundamental ownership transition. Concerning inflation's implication on production, the price mechanism ceases to signal relative changes in prices due to the general blur created by the sharp rise in the price levels. Consequently, ineffective producers could retain their position on the market because of inflation. From that, Kornai (1990: 110) argues that the "[...] firm's budget constraint cannot be hardened; inflation softens these even in the private sector."

Hard budget constraints defined by Schaffer (1998: 81) as a "subsidy paid, typically by the state, to loss-making firms to guarantee their survival" is essential to harden in order for the creation of a private sector. These subsidies either come in the shape of a direct budget subsidy or through the provision of soft credits given to the SOEs by the state banks

(Havrylyshyn and McGettigan, 1999: 30). Kornai (2001: 1576-1582) provides with five instruments that may soften the SOEs budget constraint; fiscal subsidy, soft taxation, soft bank credits, soft trade credits and through wage arrears. The most common sources of soft budget constraints, according Schaffer (1998: 101), are soft taxation and soft bank credits. Since state control prevailed during the era of plan economy, the SOEs often operated on soft budget constraints, rendering the use and allocation of resources ineffective. As a consequence, the lack of proper incentives to internalise the cost (discussed in 2.1: 9) affected their production negatively. Therefore, a set of new laws needed to be introduced- a bankruptcy-, accounting- and a banking law. These laws would instigate the ‘creative destruction’ process. This process of natural selection is, according to Kornai (2000: 7), an effective technique for changing the ownership. Together with the implementation of proper bank laws, the banks would begin to make loan decisions based on economic parameters rather than political ones.

The new conditions originating from the transition process were in many ways the contrary to what these countries were accustomed to- and which defines the whole market economic system; *competitive markets*. The transition countries emerged from half a decade of monopoly and monopsony, where quality and customer service was to large extent neglected. In order for competition to prevail, the abolition of the central planning and price controls were prerequisite reforms. Moreover, price liberalisation- together with current account convertibility- implied an external liberalisation, which has proven to be an important source of competition in the transition countries (Havrylyshyn and McGettigan, 1999: 31).

As the price mechanism gives information about the products; more attention is placed on satisfying the demand of the customer. This argument is reinforced by Kornai (1994:39), who argues that the transition process is about going from a seller- to a buyer society. Competition also prevails on the labour markets where managers are competing for various managerial jobs, which also concerns the labour force in general.⁷ As privatisation advance, redundant workers in the former SOEs are laid off, thus creating an overall demand to supply supplementary employment opportunities. This increased demand for employment was expected to be met by the emerging *de novo* enterprises. From that, the Evolutionary approach assumes that the emerging private enterprises could substitute the role of employer after the

⁷ This is exemplified by the bureaucracy reform in China during the 90. See Groves et al. (1995)

privatisation of the SOEs. We shall further elaborate this discussion in Chapter Three, but for now we establish that the emerging classes of entrepreneurs in the transition countries face numerous obstacles. One of the major obstacles is the lack of clear property rights.

We have already mentioned the importance of exclusive *property rights* (2.1: 9) and a proper legal framework (2.3: 13). Due to the fact that the Evolutionary approach put emphasis on the importance of property right, we further need to elaborate the property right concept. The introduction of a set of (new) property laws and a reformed legal framework are fundamental in order to witness the emergence of a strong and vital private sector. Furthermore, the establishment of proper property rights should be seen as the framework within which the economic agents are acting, thus setting formal constraints and possibilities for the economic agents. Private ownership relies on the assumption that property rights are respected and that a breach of these will be enforced by the judicial system. Consequently, clear and well defined property right will further ameliorate the incentives of the private entrepreneur, thus rendering the private production more efficient than state production. However, the implications of the introduction of the property rights are numerous. Both North (1990: 51) and Rapaczynski (1996: 89) argue that the introductions of property rights in modern societies are highly complex and consideration to existing informal norms in the society must be taken in order for the new laws to work efficiently.

2.3.4 The Washington Consensus-approach

Table 2.3.2

Allocative Change	
<i>Views on Markets and Liberalisation</i>	The market will develop naturally, if the government doest not intervene
<i>Attitudes towards SOEs</i>	The SOEs need to be closed down
Governance Change	
<i>Privatisation</i>	Through fast ownership transfer. Methods usually preferred; mass privatisation.
Reform Strategy	
<i>Focus of reform</i>	Liberalisation, stabilisation and privatisation.
<i>Partial reforms</i>	Creates rents that will block further reform
<i>Views on initial conditions</i>	Create a ‘clean slate’ condition by breaking the socialist state structure

Source: Roland (2001: 34-35)

The Washington consensus approach originates from a policy document presented by John Williamson (1990). The document was originally formulated and designed for the South American economic liberalisation process in the 1980s, but had a larger impact on the other side of the Atlantic, namely in East and Central Europe. The principal focus was put on the establishment of a viable market. Put in the context of the transition process, this also implied a complete break with the old communist system and its institutions.

The fundamental view of the Washington consensus approach is that it believes on the natural emergence of the market economy (Table 2.3.2: 20). According to this view, the past has shown that the emergence of the free market has been hindered by the state's intervention in the development of the natural free market. Furthermore, at the initial stages of transition a 'window of opportunity' emerged, rendering the scope of fundamental reforms possible.

The implementation of the 'trinity' of reforms, i.e. liberalisation, stabilisation and privatisation thus play a central role in the Washington consensus approach (Table 2.3.2: 20). By breaking with the plan economy through fundamental market reforms, this view believes that the domestic markets will be forced to adjust to the new conditions. Moreover, these reforms will create irreversibility, which in turn resolves the uncertainty problem common in transition countries. Following this discussion, the swift implementation of fundamental market reform that ensures the development of a market is crucial.

Referring back to the term 'window of opportunity', the Washington Consensus approach regards the transition process as a break with the past, standing as the beginning of something new. The initial conditions are factors that are entirely disregarded by this transition approach. The so-called 'clean slate' approach is based on the swift dismantlement of the SOEs (Table 2.3.2: 20). The intellectual rationale is that the past problems experienced by the transition countries originate from too much state intervention and its complete dominance in the economy. As a consequence, the swift transfer of ownership is vital to ensure the development of a functioning market. The argument for a swift ownership transfer is the result of a belief on an inherent misallocation of resources made by SOEs, and from the expected benefits that would follow from private ownership (Roland, 2001: 38). The significance and scope of these gains depend, to large extent, on which privatisation methods a country utilises. Before we proceed further, this study will briefly discuss the most urgent constraints that the privatisation process faced in the East and Central European countries.

The first and most imminent constraint was the shortage of savings. From the discussion in 2.2 (12) and 2.3 (13), both the theory and the evidence demonstrate that the savings had left to wither away due to the high levels of inflation. This engendered multiple problems for the reformers in the transition countries. The implication on privatisation was mainly that the methods, envisaging sales to the citizens, was largely limited.

The second constraint was the establishment of ownership rights and an effective legal framework that would secure the privatisation of SOEs. Various problems could arise where the new owners used assets that were in de facto owned by the state. The former could reclaim these assets after the privatisation was completed, thus accentuating the disorder in the transition process. The most apparent problem it generated in this case was an unclear business environment. As a consequence, these uncertainties would engender a shortfall of important tenders in the privatisation process and deter much needed foreign investment.

The third constraint was the absence of a market that could value and set the price of the firms- i.e. the capital markets. Earlier reform process (e.g. in the UK) relied on the stock market to value the SOEs (Estrin, 1994: 34 and Brada, 1996: 68). But as the challenge of privatisation, according to Lipton and Sachs (1990: 294), is to “[...] combine the redefinition of property rights with the creation of vital financial markets institutions”, the need to create a stock market or circumvent the former *ad hoc* was a precondition for the privatisation process to proceed efficiently and engender revenues to the state.

2.3.5 Privatisations Methods

The way privatisation is advocated by the Washington consensus-approach was through the sale of the SOEs, utilising various methods. From the literature (Estrin, 1994; Brada, 1996; Lipton and Sachs, 1990; Kornai, 1990; Megginson and Netter, 2001; Havrylyshyn and McGettigan, 1999) reviewed, three interesting privatisation methods are worth examining; *mass or voucher privatisation*, *direct-* and *indirect privatisation*. The two first methods are a direct response to the constraints discussed above, while the third method was predominately employed when the capital markets had been established. The two first methods were implemented *ad hoc*, because, firstly, the initial conditions in each country varied (see 2.3.1: 19) and, secondly, there was no previous record on how to best execute the *direct privatisation* and the *mass privatisation* programmes in a transition environment. On the

contrary, the *indirect privatisation* method relied on the experience gained from the developed countries but faced the most difficult constraint to circumvent; i.e. the non existing capital market.

From that, there is a need of providing the basic background of *mass privatisation*, which is followed by an analysis of *direct- and indirect privatisation* methods.

According to the theory, the fastest way to privatise the SOEs and launch the development of a dominant private sector was through the *mass or voucher privatisation* (Megginson and Netter, 2001: 339; Havrylyshyn and McGettigan, 1999: 22; Sachs and Lipton, 1990; 322). Advocates of this method accentuate, besides its advantage in speed, that it allows the privatisation process to proceed even though a chronic saving shortage subsists in the economy.

The *mass privatisation program* (MPP) implied the mass sell of SOEs to the population. All eligible citizens could participate in the bidding by acquiring a voucher, either by buying it at a nominal price or obtaining it through a state distribution system. Thereafter, the holders of these vouchers could freely bid for shares in various SOEs. As the initial condition varied in the transition countries, the mass or voucher programs were designed differently, rendering a general description of this method problematic. However, from the experience of countries where this privatisation method was employed, we can draw a number of conclusions on what characterised this privatisation method. Three constraints were presented in section 2.3.4 (20), and mass-privatisation resolved or circumvented two of these constraints theoretically. First, concerning the shortages in savings, the voucher programs created a stock of savings that would be matched by an equal stock of state assets (Brada, 1996: 72). Therefore, the lack of savings on the microeconomic level did not halt the privatisation process on the macro level, due to the pooling of the limited resources (i.e. savings) together. In order to organise this concentration of capital, investment funds and other financial intermediaries were engaged in the privatisation process. Holders of the vouchers allocated these in investment funds and then made the bidding on behalf of the voucher holders. In this context, the emergence of a capital market was to be expected, which could resolve the third problem -concerning the valuation of the SOEs. From that, the equilibrium price was set when the bids matched the supply. The appeal of this privatisation method was first its speed and secondly the expected equal distribution of shares of the former SOEs to the population. As a consequence, this

privatisation method was promoted on its equality abilities and, therefore, perceived as the most democratic method of the three methods discussed in this study.

Opposed to the former method, *direct-* and *indirect privatisation* was both perceived as an extensive privatisation procedure. Firstly, it should be noted that the IPO process- *indirect privatisation-* consists of a comprehensive restructuring and valuation process requiring time and financial means. In addition, the success of this method is largely due to the proficiency of the capital market, which was lacking in the transition countries. Secondly, restructuring a SOE – *indirect* and *direct privatisation-* entailed a total revision of the SOEs financial state, an evaluation of its capital assets and the complete revision of the employment structure. The evaluation process, conducted *ad hoc*, together with the theory expect that during the initial privatisation period revenues generated from the IPO schemes would be limited, thus placing more importance on the direct privatisation method to yield revenues for the state.

Direct privatisation implies the sales to either the management or the employees of the SOEs. This form of privatisation does not assume the legal or the organisational form as a Treasury corporation. From that, this method is more decentralised as it leaves the privatisation decisions to the management of the SOEs. The price is evidently set low due to the limited amount of capital accumulated by the managers and owners. The privatisation of state property consequently faced a major trade-off. On the one hand, the state objective was to produce revenues from privatisation and, on the other hand, to hasten the restructuring of the firms, therefore implying the sale of state assets to private entrepreneurs. As the latter was scarce commodity with limited financial capital, the sales of state property could not be employed on large industries. The reason for it is that such a sell would generate limited revenues from the state and therefore would not fulfil the revenue objective set by the government. Consequently, privatisation through this method- the sale to insiders- is best suited for small service establishments (Brada, 1996:70). In theory, this method could lead to an efficient outcome if the established corporate governance structure aligns the incentives of the workers and the owners (Havrylyshyn and McGettigan, 1999: 21). However, Havrylyshyn and McGettigan (1999:21) argue that insider-dominated firms “[...] may end up granting excessive wage increases, [...] maintain above-optimal employment and undertake insufficient investment”. This reasoning implies that insiders lack the necessary skills needed in a market economy. The result of this method could give rise to fears of postponing the restructuring of the SOE and a fear to allow outside ownership.

Indirect privatisations involve the corporation process of the SOEs. The SOEs are turned into corporation owned by the state Treasury. As a result, this method is controlled by the state and relies on the capital markets as opposed to *direct privatisation*. The rationale behind selling state assets to outsiders in indirect privatisation (foreign investors)- through IPO sales and tenders- is mainly due to the underdevelopment of the domestic capital markets (constraint three) and the lack of savings (constraint one). Furthermore, foreign ownership would most certainly result in new production technology, finance and market experience (Estrin, 1994: 37). These important factors in production are vital for the future efficiency of the SOEs in general and the economy in particular. However, as the lack of the second constraint (property rights) is obvious at the onset of transition, foreign investors are expected to be inclined to invest in countries where political uncertainty prevails. An additional constraint against this method is that it will find limited support among the public. Foreign ownership is often perceived as the transfer of wealth and control from national citizens to foreign owners. As a result, limited support for this privatisation method is evident (Kogut, 1996: 294). Consequently, the use of outsider privatisation should, initially, play a limited role in a privatisation program. Nevertheless, this method could be used at a later stage in the privatisation process, when the new conditions of the market economy have been established, i.e. when the property rights are secured and capital markets are established.

2.4 Summary

The rationale of why privatisation is needed and private ownership is a better form of ownership, is due to the fact that of private entrepreneurs are profit maximizers and internalise their costs. From that, private owners have stronger incentives to run their firm more efficiently than a state manager, because the former is perceived to have soft constraint and make decisions not only on economic variables but on political variables too. Privatisation regarding the transition countries is particular urgent, since their (state) economies are characterised by inefficiency and instability.

From the theoretical discussion, three clear aims with privatisation emerge. The first concerns the complete separation between the state and the private sector, which is prerequisite for the emergence of a dominant private sector. As a consequence, the second aim is the creation of a private sector. The third and final aim is that privatisation should generate revenues to the state, which is important for the continuous transition process.

The two main approaches surveyed in this chapter are; the Evolutionary-approach and the Washington consensus-approach. Although one should analyse these two approaches as complementary in their mutual objective to create a dominant private sector, there are fundamental differences in these measures employed to tackle the problems arising from privatisation. The fundamental difference is the question of speed. While the Evolutionary-approach argues for the organic development of the private sector, the Washington consensus-approach stresses the importance to grasp the 'window of opportunity' that the fall of communism presented before the East and Central European countries. The second difference lies in the methods used to achieve the objective of a dominant private sector. The Evolutionary-approach focuses mainly on establishing a market environment that is favourable for private sector growth- i.e. macroeconomic stability, hard budget constraints, competitive markets and well defined property rights. The Washington consensus argues that the creation of a private sector is best made through different privatisation methods of SOE sales. This study has highlighted three forms of constraints (savings, property rights and capital markets), which generate different privatisation methods. These privatisation methods are identified as; *mass or voucher privatisation, direct and indirect privatisation.*

3 The Polish Approach

This section of the study covers the empirical findings made from the Polish case. Firstly, this study evaluates the initial condition in the Polish economy, which is expected to determine the relative success of the privatisation process. Secondly, thoughts are exposed regarding the elaboration of the design of the stabilisation and liberalisation program. Thirdly, the Polish privatisation process is analysed in depth. This analysis commences with the privatisation 'from above' supported by the Washington consensus approach. Then, we conclude this section with an evaluation and analysis of the privatisation 'from below', the method promoted by the Evolutionary approach.

3.1 Initial Condition

The effects of the initial conditions on the privatisation process are substantial. In this section, efforts are made to show evidence of the theoretical assumption that reform efforts prior to transition had an important effect on changing the economic behaviour of the economic agents in Poland. An increase in the efforts to liberalise the economy prior to the transition is an important factor when explaining the shift in the economic behaviour of the population. As a result, the change in the informal norms is highlighted as particularly important to the privatisation process, as it makes the economic agents more inclined to take risks and allocate resources more efficiently. The share of private sector in 1989 is the result of the former factor and an indication of the required comprehensiveness of the privatisation program. The macroeconomic environment signals how urgent the need for a liberalisation and stabilisation program is in Poland. With an urgent need, the privatisation process is likely to be postponed and the initial support for the privatisation process could be lost. However, if the need is less urgent, the context is more likely to favour a privatisation process that proceeds simultaneously with the stabilisation and liberalisation program (the Polish program will be discussed in-depth in 3.2). As a consequence, the initial conditions are important indicators of the direction, design and comprehensiveness of the Polish privatisation program.

Prior market reform efforts. After the economic crises in the late seventies, under the leadership of Prime Minister Messner, the Polish communist regime initiated an economic program which came to be defined as the start of the 'dual-track' economy in Poland. The program envisaged a reduction of the 'red tape' in order to facilitate the process of setting up new businesses in Poland. Consequently, the accounting requirements which had long

hampered the establishment of any new business starting up in Poland were simplified and, in addition, the private entrepreneurs were given permission to interact with the state sector by supplying semiproducts to the former (Poznanski, 1992: 642-643). The establishment of these new reforms came from the fact that the governments -following the deep recession of 1979-82 -realised that the level of living standards could not be upheld with the present economic system in place (Lipton and Sachs, 1990; 103-104). Subsequently, these reforms were a response to the production loss that the state sector had experienced. Consequently, the reform was an effort to enhance the efficiency of the SOEs, by facilitating the establishment of private enterprises who could supply the SOEs with necessary materials and semiproducts, thus rendering a more efficient economy. The reform enacted in the late 80s was also a tentative to allow more private participation in the economy, but without promoting any ownership change. As a result, and to the chagrin of many Poles, these reforms failed to invigorate the economy (Lipton and Sachs, 1990; 106). However, as opposed to Lipton and Sachs (1990), one cannot disregard the positive effects of these reforms. One can conclude that in the short term the dual-track economy had a minor effect on the economy. However, in the long run these reforms must be perceived as the introduction of market economy norms (i.e. risk taking and cost-benefit calculations) to the Polish society. Additional reform to stimulate private sector in the late 80s further enhanced the private sector incentives in general. By liberalising prices paid to farmers, and by lowering taxes on wages paid by private enterprises, the Polish policy makers encouraged more private interest to enter the economy.

As a consequence, the *share of the private sector* in 1989 reached 30 per cent, a relative large share compared to Hungary (10 per cent) and Czechoslovakia (2 per cent) (Estrin, 1994: 7). Poland's high share of private sector is due to, besides the above mentioned reforms, the fact that the agricultural sector had been in 'private' hands since the early seventies. However, farmers were forced to deliver certain products at pre-determined prices and the state controlled the distribution of materials together with the overall supplies of the agricultural products, which does not correspond to what is normally defined as privately owned. Moreover, during the late 1980s, successive governments had forced failing SOEs to be converted into joint stock companies. Although the state owned a majority of the shares in these firms, it was often together with foreign investors. These 'cross-ownership' in the heavy

industry sectors, which were defined as private, also helps to explain the enhanced share of private sector in the economy.

The sectors in which the private enterprises operated - besides the agricultural sector- were the service-, retail-trading- and manufacturing sectors (Estrin, 1994: 219). This was due to the economic structure in Poland, which was naturally dominated by the state, leaving little room for private economic activity. In 1989 the state sector- as share of GDP- controlled 70 per cent of the economy. The state ownership was concentrated in the heavy industry sector, which was a general strategy employed by the majority of the former communist countries. Accordingly, the state dominated the industry-, construction- and the infrastructure (utility and petroleum) sectors. From that, the employment structure followed the ownership structure of the state, with the state employing 70 percent of the total employment in the industry sector and 85 per cent in the infrastructure sector in 1989 (Estrin, 1994: 220). As a result, the heavy industries, controlled by the state, indicated the direction of the privatisation program; privatisation would commence in the service-, trade- and manufacturing sectors, while the privatisation in the heavy industry sectors was expected to be more sluggish.

The poor macroeconomic situation in 1989 was due to the balance of payment crisis that emerged in the early 1980s after Poland had accumulated a substantial foreign debt. Although its regional neighbour, Czechoslovakia, started with similar macroeconomic conditions in the 1980s, Poland found itself in a more troublesome macroeconomic position a decade later. The 70s had been characterised by access to cheap credit and economic growth throughout East and Central Europe. When these countries entered the 1980s, they had accumulated a substantial foreign debt and there were two ways to solve the imminent macroeconomic predicaments. One path was to reschedule their debt service obligation and enjoy higher economic growth. The alternative way was to repay their debt at the expense of slow growth, but enter the 1990s with healthy macroeconomic levels (Estrin 1994: 8). Concerning Poland, its austerity program -introduced to solve the balance of payment crisis in the late seventies- did not allow for extra budgetary expenditures in the form of interest payments on foreign debts. Consequently, the foreign debt accumulated.

The living standards had stagnated and even deteriorated following the economic crisis in the late 1970s. During this gloomy period, Poland saw the emergence of the Polish trade unions in general and one, Solidarity, in particular. As the trade unions led by Solidarity grew

stronger, their demands of an increase in the overall wage levels forced the government to succumb to these demands. As a result, the inflationary pressure that had been building up since the early 1980s was unleashed. In addition, two illustrative factors are discussed by Lipton and Sachs (1990: 110-111), contributing to the hyperinflation in 1989. Firstly, the households were given legal access to foreign exchange, which led to the abolishment of the black market and subsequently a flight from the zloty. Secondly, standing as “the last important reform carried out by the communist government”, the liberalisation of retail food prices and the reduction in food subsidies were contributing factors. Consequently, inflation reached staggering heights of 243.8 per cent, thus dispersing the savings kept by the Polish population (Slay, 2000: 52). As a result- and as was prescribed by the supporters of the Washington consensus and the Evolutionary approach- Poland found itself in an unsustainable position and had to stabilise and further liberalise its economy before it could embark on the privatisation process.

3.2 Stabilisation and Liberalisation

The stabilisation and liberalisation process consisted of four reinforcing policies. These policies were divided into two groups. The first group (issues one and two) of policies envisaged the reduction of the state interference in the market and an overall preparation for privatisation through the restoration of the macroeconomic imbalances that had been offset during the austerity program in the 1980s. The second group (issues three and four) focused on the liberalisation of the administrative prices and on introducing foreign competition to the Polish economy by implementing price liberalisation and currency convertibility- i.e. internal and external liberalisation.

The first group and issue relates to the restoration of the state budget. Due to high cost for the state derived from subsidies and investment outlays, the government was forced to introduce necessary measures that would rebalance the state budget. The rationale behind this argument was that excessive state consumption fuelled inflation and extorted private capital from entering the Polish market. Therefore, it was vital that these externalities were curbed, as they hampered the overall privatisation process. From that, the government reduced its subsidies and investment spending dramatically during the first years of transition. Moreover, this shift of limiting state intervention also implied an additional break with the past. In this context, the government sought to replace the state with private enterprises in providing public services,

e.g. the pension system was envisaged to be managed by the capital market rather than the state, thus reducing the outlays of the government substantially.

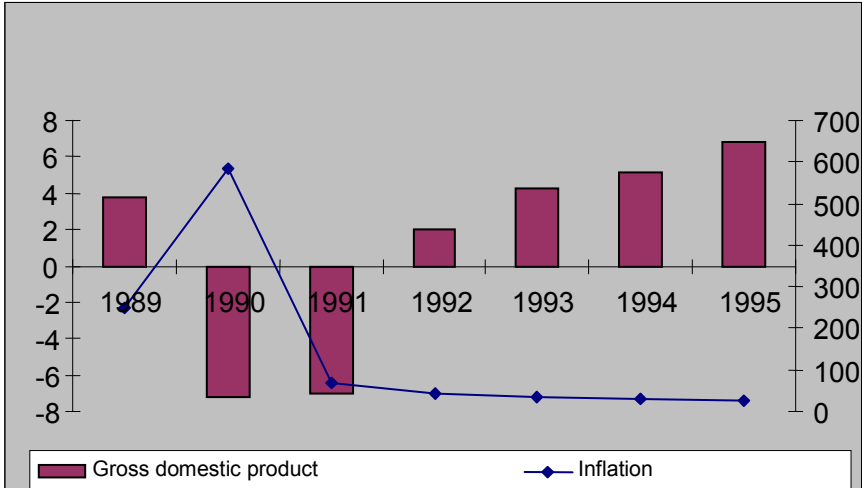
The second issue revolves around the cheap credit offered by the state banks to state companies. This inherent soft budget constraint had fuelled inflation during the 80s and the beginning of the 1990s, by financing defaulting SOEs. The need to render harder the budget constraint was vital to the future growth of the Polish economy in general and to the privatisation program in particular. The hard budget constraint was vital in the privatisation 'from below' when creating a market environment that promoted private sector development (see 3.5)

These two issues were regulated by the government soon after the stabilisation and liberalisation program was introduced in Poland. According to Lipton and Sachs (1990: 117), subsidies and investment spending were reduced by 8 per cent of GDP at the initial stages of the stabilisation measures. Furthermore, the fiscal balances were further improved by the fact that the Paris and London Club wrote off 50 per cent of Poland's foreign debt in 1991 (Slay, 2000: 57). In addition, high interest rates and improved supervision of the activities of the major commercial banks in Poland tightened the credit expansion, thus hardening the budget constraint. Even though the fiscal balances were improved substantially during the initial phase of reform, two remaining issues had to be resolved that would aggravate the fiscal balances further by fuelling inflation; price- and currency liberalisation.

As the administrative controls over prices were lifted and the *zloty* was made convertible to foreign currencies; inflation soared. Liberalisation of prices and the convertibility of the Polish currency stood for a necessary one-time adjustment to the economy. Currency convertibility-implicit to external liberalisation- became an effective anti monopoly tool and served Poland well by introducing foreign competition (Lipton and Sachs, 1990: 118). By liberalising the prices and creating currency convertibility, the Polish government laid the basis for a market economy but also offset inflation pressure. In addition, during the 1980s the living standard had deteriorated substantially and the demand for real wage increases among the Polish workers strengthened. The government intended to resolve this issue by decentralising the wage setting process to the SOEs, rendering the wage setting process more efficient. Furthermore, it was initially believed that the strength of the workers councils in the SOEs was fundamental to the success of the privatisation program. Therefore, the government

went far to meet the demands of the workers. As a result, the managers of the SOEs were given more freedom to negotiate with the worker. The pressure from the workers was too strong and the managers could not restrain from their demands but had to concede to their wage demands. As a result, inflation further deteriorated. In a tentative to hinder inflation incorporated into the wages, the government introduced a prohibitive taxation on excessive wage growth in the SOEs.

Figure 2 GDP growth vs. Inflation in Poland, annual change, 1989-1995



Source: IMF Economic Outlook 2006

From figure 2, a clear picture about the impact of inflation on economic growth emerges. As Poland embarked on its stabilisation and liberalisation program in the early 90s, inflation had already reached a high level (surpassing 200 per cent in 1989). In 1990, the program was put into full force and resulted in even higher inflation. As a consequence- and in accordance with economic theory- the GDP contracted and the Polish economy experienced two years of negative growth. Although inflation was never brought down to single digits during the first five years of transition, inflation was stabilised, which made it possible to plan the economy over a longer period of time. In the context of the privatisation program, the equilibration of the macroeconomic imbalances was prerequisite for the implementation of an extensive privatisation program. In addition, the stabilisation of the inflation levels reduced the atrophy of the Poles’ savings, thus slowly improving the Polish purchasing powers. In addition, with the macroeconomic environment in balance, Poland could commence its privatisation program.

3.3 The Polish Privatisation Program- Timing and Sequence

The time of the expected privatisation process was characterised by political and social uncertainty. The political uncertainty infused in the transition process had particularly grave consequences in the Polish case. In the Polish privatisation process, three parties were involved; the worker council, representing the employees, the founding body, representing the State Treasury, and the outsiders, represented by foreign investors (Baltowski and Mickiewicz, 2000: 432). According to Baltowski and Mickiewicz (2000:432), these parties hampered the privatisation process substantially due to the fact that they sided with each other in various constellations against the third party. This left the overall privatisation on hold. Furthermore, the stabilisation and liberalisation program was not approved by the Polish people who proclaimed their discontent by voting off one government after another during the initial stages of transition. This evidences the *ex post* constraints discussed in 2.3.1 (14), which accentuated the problems of reversing the privatisation program through the rejections of several governments, thus highlighting the widespread uncertainty prevailing in post communist Poland.

Given these initial constraints, the path chosen concerning privatisation was in line with the theory- i.e. traditional industries were saved 'for later', turning the privatisation focus on industries where positive results could be achieved fast, thereby reducing the opposition towards the privatisation process. However, even the 'easy' (i.e. direct) privatisation programs became complicated due to the relative strength of the interest groups and the relative weakness of the state in the negotiations that took place prior to privatisation. In addition, Poland faced another major obstacle; the lack of national savings. In an attempt to circumvent this constraint, the Polish government presented the legal framework for mass privatisation program to the Sejm in 1990.

3.4 Privatisation 'from above'- The Washington Consensus approach

The three constraints mentioned in 2.3.4 (20), were imminent in Poland at the time of privatisation. The national savings had been eroded after many years of hyperinflation during the 1980s and early 1990. Moreover, the state of disorder that characterised the Polish society had led to unclear and insecure property rights. The third constraint, i.e. the problems of

valuing the SOEs, were in one hand caused by a deficient capital market, on which the SOEs could be valued on and, on the other hand, caused by the total collapse of the communist block. The capital market constraint was predicted but the total collapse of the communist block was not envisaged to proceed so rapidly. According to Lipton and Sachs (1990:124), output in industrial production contracted by 30 per cent during the first years of transition. As a consequence, it became clear to the Polish policy makers that they needed to instigate a privatisation process as swift and as comprehensive as possible. An option favouring a mass privatisation program was evoked in the latest 1980s by a liberal economist from an economic institute in Gdansk. Though this suggestion was rejected at that time, it arose once again as Poland needed to overcome the accumulating obstacles to the privatisation process. From that, the Washington consensus came to set its impression on the Polish privatisation program and the speed was of prime importance to the privatisation process. The *ex ante* expectations of privatisation- that a swift privatisation would circumvent the political disputes- was not met straightforward. The inherent lack of consensus building among Polish legislators put the mass privatisation process on hold. Rather, the *direct* and *indirect privatisation* methods emerged as the key privatisation methods in the Polish privatisation program.

3.4.1 Privatisation Methods

Direct privatisation. In order for the SOE firm to become privatised through *direct privatisation*, it had to be evoked by either the founding body (the branch ministry) or through a joint request by the managing directors and the worker's council with the consent of the state Treasury. In response to the reduced powers of the employees, an incentive structure had to be constructed in order to gain the support from the employees. As a result, the employees could acquire the shares of the firm on sale, to a discounted price of up to 50 per cent (as opposed to investors who paid full price) and, in addition, the prohibitive wage tax that had been introduced during the stabilisation and liberalisation program was partially removed. Consequently, it is evident that the Polish insiders played a pivotal role in determining whether the privatisation process is to become a success or not.

The sales of the SOEs were executed through a public auction or through the negotiation with selected investors. This method of privatisation concerns medium and small companies who were in dire need of investment. The sale of SOEs through public auctions and negotiation

was straight forward. Investors and insiders were invited by the ministry of Treasury who was in charge of the sales, to take place in the bidding. The insiders had a natural advantage over 'normal' investors, as they were given more preferential terms of acquiring the shares (see previous section). One method of particular importance within the *direct privatisation* for the promotion of private ownership was the privatisation through liquidation. This method became the main engine in the privatisation process during the first half of the 1990s (Estrin, 1994: 229). The mode of operation for this method is that the enterprise in question is dissolved as a SOE and its former employees set up a new company. The new company takes full or partial control over the assets of the liquidated SOE. As a result, this method was popular among the employees (the insiders) of the firm, because they were treated in more preferential terms concerning access to assets of the SOE. Furthermore, liquidation became increasingly more important as the Polish SOEs faced stiffer international competition. Instead of filing bankruptcy for the whole SOE, parts or departments were sold out to investors or became a contribution in kind to a new company (Estrin, 1994: 231). This method was an efficient technique to privatise the SOE as it was popular among the masses and perceived as fair process. However, *direct privatisation* was not as comprehensive as the Polish government had first hoped the privatisation program to be. There were also doubts about the aptitude of the management to restructure the company in an efficient manner because the old management remained intact. In addition, the *direct privatisation* method proceeds gradually, which contradicted the official strategy of the Polish government and the Washington consensus' view on privatisation.

The theoretical implication about *direct privatisation*- i.e. the overall fear that insider privatisation would result in above optimal employment- in Poland was not in accordance with the empirical findings made regarding insider privatisation. Kotowski and Zagozdzińska (Central Statistical Office, 2004: 15) established that on overall the privatised firms- even insider firms- reduced the average numbers of their employees by approximately 36 per cent while the state controlled firms, on average, reduced its employment with 33 per cent during five years in the 1990s. It appears that privatisation- even though with an inefficient method- is significantly better than conserving state ownership. This finding is further supported by the study of Claessens et al. (1997: 15) who concludes that "[...] across all countries [Czech Republic, Hungary, Poland, Slovenia, Slovakia, Bulgaria and Romania] ownership is important; privatized state enterprises clearly outperform the still state owned enterprises [...]". However, it was problematic granting increased powers to the insiders of the SOE;

Pinto et al. (1993: 218) found evidence from a sample of recently privatised manufacturing firms that “managers served as the pleasure of the workers councils and there was insufficient emphasis on the long term viability of [the] enterprise”. The increased powers granted to the SOE insiders were due to the prevailing political realities in the country. Political uncertainty and an overall scepticism towards the privatisation program left the successive governments with a limited scope of privatisation options, forcing the policy makers to make inadequate attempts to accelerate privatisation, thus creating an inherent opposition towards privatisation ‘from above’.

Indirect privatisation; is the sale of large SOEs through initial public offerings (IPO) or public tenders. The privatisation programme submitted to the Polish parliament, the *Sejm*, envisioned privatisation to be executed in two steps. First, the SOEs should be turned into a stock holding company- owned by the state treasury -and then, secondly, these aims to be gradually sold to private individuals (Poznanski, 1992: 644). This initial step of privatisation was termed corporation and was the first stage in the SOE transformation. The aforementioned method was employed at the onset of transition in 1990. However, as this method is the most complicated method- usually used in developed countries on SOEs with sound financial health- it played an important role in the privatisation program by generating substantial revenues to the state. From that, this method turns to capital strong investors- i.e. foreign investors- to purchase the SOE. The *indirect privatisation* method should be regarded as a tentative to circumvent the lack of savings and of a capital market, by attracting foreign investors and, consequently, creating a capital market. However, the general perception in Poland was, at that time, that foreign ownership would result in employment reductions and, as a consequence, widespread unemployment. The political constraints facing the policy makers were immense. Yet, the Polish governments understood the importance of foreign participation in the privatisation process. Therefore, in a hope to attract foreign investors, the *Sejm* passed several laws intended to encourage foreign investment. Preferential terms were given to foreign investors through tax breaks and the repatriation of 100 per cent of net profit and in invested capital. With only two out of twenty SOEs sold in an IPO in 1990, the indirect privatisation method was not widely used during the first years of privatisation. This was due to the lack of a Polish capital market- Warsaw Stock exchange began operating in 1991. Furthermore, there was a widespread reluctance among foreign investors to take control of existing SOEs due to the problems that arose from vociferous labour disputes and general political uncertainty (Rondinelli and Yurkiewicz, 1996: 151).

Mass Privatisation. After five years of political haggling over the design of the mass privatisation program, this one was finally amended in the Act on privatisation of State Enterprises in 1995. This act stipulated the transfer of shares in a preferential way to a third party. Having completed the corporation process, the SOE was sold to one of the 15 national investment funds (NIF) that were established *ad hoc* to restructure the SOEs (Kruczalak-Jankowska and Kruczalak, 2003: 233). In 1995, the mass privatisation program allowed Poland's 27 million adults to acquire an investment security for 20 zloty (Puntillo and Ibsen, 1996: 44). From that, each security holder could exchange these on Warsaw Stock Exchange (WSE). In total, there were 512 SOEs that met the criteria -set out by the government- of seize, profitability and viability of operating on a free market. Thereafter, these enterprises were divided between the 15 NIF. The overall objective of the NIF was to create a favourable corporate governance structure and improve the efficiency of the enterprises. The ownership consisted of the state (25 per cent), NIF (60) and the workers (15 per cent).⁸ This owner structure stood in sharp contrast to the mass privatisation program used in Czech Republic and Russia, where the worker initially was given majority share of the vouchers. The declared aim by the state was that it intended to create a clear corporate governance structure. The most unexpected with the Polish choice of ownership structure is the fact that the state retains 25 per cent of all shares in the firm. This opposes the notion advocated by Kornai (1990: 62), that in order for the budget constraint to hardened, the government share in the firm must be limited. The main fear was that the state was not going to be as effective as the private entrepreneurs in advocating for necessary financial restructuring.

As the second phase of the mass privatisation program had been completed, the remaining assignment was the listing of the NIF on the Warsaw Stock Exchange (WSE). This phase was the prelude to the final ownership transfer from state to private shareholders. In 1997, the decision was made to list all 15 NIF on the WSE. Hashi (2000: 23) concludes that the NIF ownership has been a success by the fact it clearly tied the remuneration of the owners and managers to the profitability of the firm, thus making the restructuring process efficient. As was clearly anticipated by the theory, the incentives of the owners had aligned with that of the manager in Poland. Thus, efficiency gains were made both at the micro- and macro level.

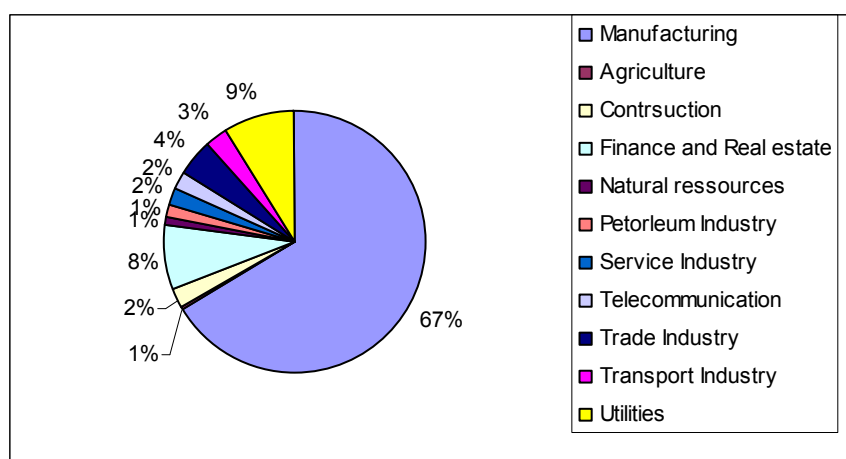
⁸ In the Russian mass privatisation program, the share to the workers was 51 per cent.

3.4.2 The outcome from ‘privatisation from above’

The privatisation ‘from above’ in Poland during the period 1990 to 2004 saw a total of 5583 SOEs start the privatisation process. In 2004, 1537 corporation- owned by the state treasury- had been established (*Privatisation-General Information: 15*). Among the privatised firms the main focus has been on firms in the manufacturing sector (see Figure 3: 38). The rationale for this result can be derived from the Polish governments’ extensive use of the *Direct Privatisation* method. The manufacturing firms possessed the necessary attributes conferred to this method; these firms were often small or medium sized, and in possession of products which were relatively easy to adapt to the new market conditions and which were facing competition from the emerging private entrepreneurs in the domestic markets. Mikolajcyk and Roberts (2006: 376-377) who studied 800 firms in the manufacturing sector, found that the size- smaller firms stood a greater chance to receive the consent of the state- is significant prior for being accepted into the Polish privatisation program. Furthermore, Mikolajcyk and Roberts (2006: 377) also suggest that manufacturing firms with urgent need for short term credit considerably reduced the chances of being privatised. These empirical findings were in part in accordance with statements made by the Polish government at the onset of reform; privatisation should first focus on ‘easy’ privatisations, which would yield positive support for the privatisation process among the workers in order to create momentum for the future privatisation process. These findings also highlight the failure to privatise financial ‘unhealthy’ firms.

From figure 3, we observe that the financial sector played an important role in the privatisation process. According to *Privatisation- General Information(28)*, 14 banks are controlled by Polish investors, while 45 banks are owned by foreign capital. The role played by the state has been reduced considerably during the years when the study was conducted. The State- through the Treasury- is the owner of three banks, of which two are being put up for privatisation. This fact shows evidence that the state’s power of giving soft budget constraint through bank credits appears to be diminishing.

Figure 3, Sector Privatisation in Poland, 1990-2004



Source: Privatization Barometer

From the fact that ‘easy’ (i.e. small and medium size SOEs in a competitive environment) privatisation schemes were initially employed, it is apparent that the *direct privatisation* method led to relatively low revenues compared to the *indirect Privatisation*. Although the former method was more complex, time consuming and perceived as a more uncertain method of privatisation than *direct privatisation*, the IPOs substantially generated more revenues to the Polish state than the direct privatisation method did. This becomes evident when analysing table 3.4.1.

Table 3.4.1 Direct and Indirect privatisation revenues (millions USD) and Foreign investors share in Privatisation (%)

Year	Total Revenues	Indirect privatisation	Direct privatisation	Foreign investors share in privatisation (%)
1991	170,9	140,5	30,4	55,80
1992	372,7	238,5	134,2	57,61
1993	433,6	274,1	159,4	43,86
1994	724,9	578,1	146,8	14,76
1995	1100,7	931,5	169,2	49,12
1996	1442,2	1067,8	374,4	27,41
1997	2043,0	1930,8	112,2	24,75
1998	2079,0	1947,0	125,9	15,49
1999	3422,4	3320,4	99,7	77,40

2000	6263,1	6161,4	101,1	81,38
2001	1666,0	1577,4	88,4	76,94
2002	702,6	633,7	68,8	70,28
2003	1065	1004,1	61,1	79,30
2004	511,5	475,3	36,2	
TOTAL	21751,6	20055,3	1686,9	58,90 ⁹

Source: Ministry of Treasury, 2004

Initially, the differences in the contribution to total revenues between direct and indirect privatisation was limited to 100 million USD, but while the privatisation process advanced, the differences between these two methods increased. In 2004, indirect privatisation accounted for about 92 per cent of total revenue compared to the mere 7 per cent contributed by direct privatisation. The complete dominance of latter privatisation method is partially derived from the rapid establishment of a Polish capital market in 1991, which resolved the clear valuation problem inherent in the privatisation process in transition countries. As the IPO consists of offering shares on the Warsaw Stock exchange (WSE), information about the financial prospects, size and value was disclosed to the public prior to privatisation. As a result, investors- both foreign and domestic ones- were attracted to invest in and bid for Polish companies. As a consequence, the foreign share in privatisation revenues grew substantially during the period 1990-2004. From the information presented in table 3.4.1, foreign participation accounted for 81 per cent of the total privatisation revenues in 2000 (when privatisation revenues peaked). The reason behind the high level of foreign participation in 2000 is explained by the privatisation of several Polish utility companies to strategic investors, which yielded large revenues to the total amount. An explanation for the overall foreign participation (58,9 per cent) in the Polish privatisation process could be derived from the favourable legislations that were introduced in the early 1990s to attract foreign investors (see 3.2: 30).

The mass privatisation scheme played an insignificant role in the Polish privatisation program. The 512 SOEs owned by the 15 NIF and sold to the public in 1997, did not alter the course of the Polish privatisation process. The initial prospects of a rapid privatisation process was never materialised due to political constraints and to the inherent structures in the SOEs

⁹ Foreign participation as the share of total revenues

who opposed this method of privatisation. The failure to implement the mass privatisation program early in the privatisation process, illustrates the disappointment of the Washington consensus- approach in Poland.

3.4.3 Evaluation of the Washington Consensus-approach in Poland

Table 2.3.2 (20) is reconsidered for this section. By reviewing the different aspects particularly important to this approach, various conclusions can be made. It appears that the preferred reform strategy anticipated the problems which would arise with partial privatisation. Pictured in the Polish context, these rents- i.e. the benefits derived from the control over the privatised SOE- have been far too high to resist in the case of the insiders of the SOEs. The problems regarding partial reform, in the view of the Washington consensus-approach, were the spill over effects on the Polish privatisation program through the persistence of an *ex post* constraint. The mass privatisation program (MPP) was never implemented in the initial stages of privatisation because of political constraint and popular disinclination towards privatisation. When the MPP was finally implemented in 1996, the program had lost its core quality as a rapid ownership transformation method.

Poland's initial condition determined the outcome of the liberalisation and stabilisation program by setting both formal as well as informal constraints on the Polish reforms. The formal constraints refer to the macroeconomic imbalances initially faced by Polish economy. During the introductory years inflation soared, which resulted in the contraction of the GDP. Therefore, there was an urgent need for an extensive stabilisation program in Poland. While reforms were implemented to cope with the situation, the privatisation program was delayed, which consequently further deteriorated the scope for rapid privatisation. Moreover, informal norms appeared due to a general resistance from the insiders to restructure the SOE. This is a sign evidencing the limited knowledge regarding the new conditions that the market economic system demanded from the economic agents. Therefore, as the privatisation reform commenced, the informal constraints posed by the worker and the workers councils halted the privatisation 'from above'. These constraints were most significant in the short term and therefore limited the swift privatisation professed by the Washington consensus-approach.

The state continued to play a diminishing role in the Polish SOEs throughout the 1990s. By employing 250300 workers in companies where the state control was of 100 per cent, and an additional 200000 workers in SOEs that the state owned partially, the state retained a decreasing share of the economic activity in Poland. The Polish *direct privatisation* strategy was in line with the theoretical predictions; SOEs in sound financial health and relative successful were privatised first. However, as these SOEs were found predominately in the manufacturing sector, which implied small sized firm, the implication of this strategy was that it generated limited revenues to the state and was not as comprehensive as initially envisaged. On the contrary, the IPO schemes introduced were- due to the healthy progress of the WSE- a success in the sense that this method yielded important revenues to the Polish state. The sluggish privatisation ‘from above’ is not the obvious driving force behind the Polish private sector development. Rather, recent focus has turned to privatisation ‘from below’- the development of the of *de novo* enterprises- in order to find the answer about the private sector development in Poland.

3.5 Privatisation ‘from below’- The Evolutionary approach

The Polish privatisation process has been successful in promoting private ownership over state ownership. However, the description from the previous section elucidates the fact that the privatisation ‘from above’ can hardly explain the whole success of the Polish privatisation process. Instead, the focus is on the creation of small and medium sized firms in order to explain the astounding development of the Polish private sector.

One of the supreme obstacles to the emergence of an entrepreneur class was the inherent lack of basic know-how of the conditions on a market economy, i.e. the informal norms. In the privatised SOEs, old behavioural patterns survived, making it complicated to observe real efficiency gains after privatisation. The former reasoning is supported empirically by Havrylyshyn and McGettigan (1999: 24-25) who find that *de novo* firms performance is much better than both privatised firms and SOEs. These findings also support the notion that the larger the share *de novo* firms add to the total output of the economy, the better the performance of the whole economy would be. The fact that Poland has undergone several reforms attempts to liberalise its economy – e.g. following the economic crisis in the early 1980s- may explain the manifested entrepreneurial spirit in the economy. The initial institutional settings- i.e. the reformed economy, with laws accepting private activity- laid the

foundation for successful private sector development. According to Winiecki (2000: 508), the large share of private activity in the economy is large because is due to the freedom that the Polish enterprises enjoy.

Furthermore, the reduction of the amount of ‘red tape’ indicates that the economic interest of the bureaucrats aligns with the economic interest of the entrepreneurs. Following our theoretical discussion in section 2.3.3 (18), this study will evaluate empirically the four conditions that create the basis of a positive market environment favouring the development of *de novo* firms; macroeconomic stability, hard budget constraint, competitive markets and property rights.

3.5.1 Market Environment

Macroeconomic stability. In addition to the macroeconomic stabilisation discussion in section 3.2 (30), it is important to further stress the effects of the implication caused by high levels of inflation. As the government fought to reduce the inflationary pressure- by restricting banks to give credits and by augmenting the interest rate- important sources of funding to private entrepreneurs diminished considerably. In addition, the savings made by the citizens during the years prior to 1989 vanished. From a macroeconomic perspective, it would be difficult to observe the emergence of an entrepreneur class. But contradictory to common belief, Poland saw its stock private entrepreneurs increase by 2000 per cent from 1989 to 1993 (Grosfeld and Roland, 1996: 34). Furthermore, Grosfeld and Roland (1996: 36) report that the main source of fund came internally. These findings imply that important informal networks had developed in the Polish society, which became an important source of finance to many of the *de novo* firms. Moreover, the increasing importance of informal networks in a political and economic environment characterised by a state of uncertainty lends support to North’s arguments about the rise of an informal sector (North, 1990: 36-45). From that, this study finds that the macroeconomic stability came to play a minor role, initially, in the emergence of private entrepreneurs in Poland. However, in the long term, macroeconomic stability has been significant as it created a state of predictability, thus extending the decision horizons of the private entrepreneur.

Hard budget constraints. The unprecedented expansion of the private sector in Poland during the studied period is to a large extent derived from the fact that the *de novo* firms have been

given access to credits and capital from the informal and formal lending sector. Initially, the Polish banks were restricted to offer credits due to extensive control of the state, which focussed on stabilisation as the main objective instead of facilitating access to capital to the Polish entrepreneurs. As a result, the informal lending practice emerged as an important source of funds. In 1992, only 5,7 per cent of the private entrepreneurs' total financial support came from subsidies provided by the state. In 1993, according to Grosfeld and Roland (1996: 36) this share decreased further to 4,7 per cent. Throughout the whole privatisation process this share decreased. In 2002, a *Doing Business* survey reported that the informal sources of finance were reduced to 3,6 per cent.¹⁰ From that, it can be observed that the hard budget constraint was further reinforced by the increased participation of foreign banks and investment funds in the economy. As these financial institutions became majority owners of Polish banks, access to capital and credit was facilitated substantially through the formal procedures, thus facilitating the access to capital to the private entrepreneurs in Poland. Moreover, the hardening budget constraint implied the internalisation of cost (see 2.1: 9), rendering the firms more efficient.

In addition, the 'creative destruction' process was accentuated by the drafting of the act of economic activity, the bankruptcy law and the use of privatisation through liquidation (see section 3.4.1: 34). These issues helped to establish and develop important formal norms in the Polish business environment that would prove central to the private sector development. These issues made the business environment more competitive, forcing the economic agents to base their business decisions on cost-benefit analyses, thus yielding an efficient economy.

The two pieces of legislation- the act of economic activity and the law on bankruptcy- were introduced in the mid 1990s, to formally promote economic activity and the 'creative destruction' process in Poland. However, in the short run, their impact on promoting *de novo* firms was limited. Rather, privatisation through liquidation acted as a strong force in promoting private development and ownership transformation in the short run, by offering state assets to domestic investors. However, this method allowed both private and 'state' entrepreneurs to acquire state assets. Therefore, it is important to stress the difficulties in making the distinction between private entrepreneurs- which came from the 'outside' and 'state entrepreneurs' who came from the 'inside'. The different types of entrepreneurs are

¹⁰ <http://www.enterprisesurveys.org/ExploreEconomies/Default.aspx?economyid=154&year=2002>

both likely to exert a direct implication on the success of the firm they manage. 'State' entrepreneurs had acquired an extensive network within the state bureaucracy, which gave them an inherent advantage towards the private entrepreneurs in the short run, creating biased data of the number of entrepreneurs initially active in Polish economy and reducing the real positive effect of private ownership. It is believed that 'state' entrepreneurs lack of knowledge of the new market environment and rely too much on state assistance, thus altering the incentives and, consequently, the firm's performances (Baltowski and Mickiewicz, 2000: 434). Even though this may have been the case in Poland, it is also equally important to acknowledge the impact that this process has had in fostering a dominant private sector in Poland by disseminating the ideas of the market economy.

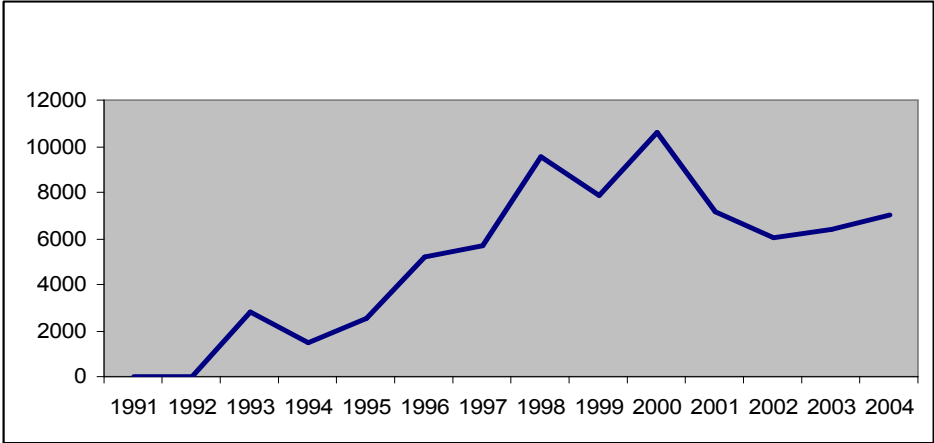
In the long run, the act of economic activity and the law on bankruptcy has strengthened the private sector development. In the Article 8 of the Act of economic activity, it is stipulated that the bureaucratic interests shall align with those of the private entrepreneurs.¹¹ Furthermore, Article 8 accentuates the importance of promoting entrepreneurial activity in micro, small and medium firms. The importance of a bankruptcy law enhances the risk awareness among entrepreneurs in Poland. The fact that businesses directly stand the risk of going bankrupt forces the management (the entrepreneurs) to proceed with a rationale and efficient decision regarding the firm's resource allocation. It appears that the 'rules of the game' were further improved by the fact that Poland had created institutional incentives to promote private entrepreneurs by introducing an exemption from the VAT (value added tax). This is additional evidence of the formal promotion of private entrepreneurship, vital to the overall progress of a private sector (<http://www.unece.org/indust/sme/smepubli.pdf>).

Competitive markets. As the stabilisation and liberalisation program cemented the Polish move towards a market economy, it left the fragile economy opened to fierce foreign competition. Initially, the fear that foreign investors would exhaust all imaginable resources to be found in Poland was unjustified. However, the fear persisted and became a major obstacle to the implementation of the MPP in Poland. Table 3.4.1 (38) acknowledges that the foreign participation in the Polish economy was significant. Therefore, the development of the Polish economy and the accumulation of FDI are closely correlated. Even though a causality problem is evident, the argument based on the fact that the macroeconomic stability that

¹¹ http://www.paiz.gov.pl/files/?id_plik=7316 and <http://www.doingbusiness.org/LawLibrary/?economyid=154>

emerged from the stability and liberalisation program attracted much of the FDI is viable in the Polish context and supported by the economic theory in general (EBRD, 1997: 69-70). From *Privatisation-General Information* (2004: 25), only a minor share of the total FDI went to the privatisation process. As Poland initiated its negotiation with the EU, much of the FDI to Poland was invested in greenfield operation, thus sharpening the overall competition as well as introducing new technology and know-how to the Polish economy.

Figure 4. FDI in Poland 1991-2004¹² (USD million)



Source: Ministry of Treasury, 2004

An important effect of privatisation was that redundant workers were laid off, thus offsetting an increase in unemployment. The solution to this problem was expected to be resolved by the *de novo* firms. However, the expectations did not correspond to the outcome on this issue. During the first years in transition, Poland experienced a relative low level of employment. This was to a large extent due to the sluggish privatisation process. As the privatisation and the restructuring process gained momentum, the unemployment soared. It is clear that the *de novo* firms did not stop to the rising unemployment by providing additional employment. The *de novo* firms are often small business-1 to 100 employees- and have neither the financial means nor the production capacity to employ redundant SOE workers (Konings, 1997:414). According to the Ministry of Economy (2004:1), small and medium firms constitute 44 percent of the total GDP. It should be noted that if these firms are not able to keep up with labour redundancies, unemployment is likely to persist.

¹² Data from 1991 and 1992 are not available.

Property rights. New laws were introduced to ameliorate the business environment in Poland during the initial phase of transition. The aforementioned laws- the bankruptcy law and the act of economic activity- had significant importance on the overall protection of the property rights in Poland. Besides their importance in creating a competitive market, these laws also underscored the importance- as well as promoting- (private) economic activity. Moreover, the laws introduced by the governments in the early 1990s to attract foreign investors had also positive effects. These new approaches form an essential part of the overall aim of securing the property rights in the Polish society.¹³ In their comparative study between Polish and Russian entrepreneurs, Shleifer and Frey (1997) argue that the Polish entrepreneurs operate in a legal environment that is- compared to the Russian environment- more supportive of business. In Poland, private entrepreneurs trust the legal system and feel that their property rights are protected. This is derived from the fact that local governments are supportive of private economic activity (Shleifer and Frey, 1997: 357).

Although it is difficult to distinguish the exact factors contributing positively to the protection of property rights in the Polish case, Winięcki (2000: 510) highlights two factors crucial to a successful privatisation ‘from below’ process; “wider framework of liberty [...] and [...] general trust” . The political safety evidenced by the free and democratic elections in Poland has ensured political safety for private entrepreneurs. This is further evidenced by the state’s declared support of private ownership. Regarding the general trust, entrepreneurs rely on the fact that the general course of the economy is not altered by newly elected governments.

The aforementioned factors yield risk-taking by creating an institutional environment that is favourable to private economic activity. Furthermore, risk taking generates strong incentives to manage the private property in an effective way by allocating the limited resources effectively, rendering *de novo* firms more efficient than both SOEs and firms privatised ‘from above’ (Frydman et al., 1997: 45; Djankov and Murell, 2002: 741).

3.5.2 Private sector success- the Evolutionary-approach

Several conclusions can be made by assessing the development of a private sector in Poland from an Evolutionary-approach. The Polish emphasis on the creation of a legal framework, favourable to private economic activity has been crucial to the surge of private entrepreneurs

¹³ The bundle of rights: the right to determine its use, the right to the earnings of the resource and the right to dispose the resource

during the studied period. This is evidenced by the Act on economic activity and the bankruptcy law introduced in Poland, which created a preferential environment for private entrepreneurs. Two important effects can be derived from these laws. Firstly, the legal system was reformed so that it would promote private economic activity. Secondly, the Act of economic activity aligned the interest of the bureaucrats with the interest of the market (i.e. the economic agents), thus creating an approach for the institutional environment to be professed as particularly important to the privatisation process.

The reforms throughout the Polish transition have strengthened the market environment. This study notes that the macroeconomic stability, the hard budget constraint, the introduction of competitive markets and property rights- in line with the theoretical expectations- are vital to the success of the private sector development. These mutually reinforcing aspects have created an incentive based market economy that reacts on changes in price and customer behaviour, rather than orders from the state bureaucrats. As a result, the Polish economy has transformed itself from a seller to a buyer society in almost one decade.

Although the Evolutionary approach was initially side-stepped by the Washington consensus-approach when designing the Polish privatisation process, the gradual approach emerged unintentionally and played a vital part in the privatisation process. The gradual approach succeeded in an area where the Washington consensus-approach failed; using and modifying existing institutions. Furthermore, the initial conditions had a pivotal role in determining the success or the failure of the different programs. This is exemplified by the implementation of the hard budget constraint. This reform was at first implemented due to the macroeconomic realities facing Poland at the onset of privatisation but came to play a significant role in creating a favourable market environment. Through the enforcement of a stop in credit lending, the state required all actors in the economy to economize, thus creating an effective hard budget constraint by complying with the institutional constraint that the soaring inflation presented. Moreover, the advantages of the gradual approach were that it did not perceive the state as 'dead'.¹⁴ Instead, the reformers worked actively with the state and initiated necessary reform at an internal level. As a result, the gradual transition allowed for the alignment of the informal- and formal norms. As a consequence, the sequence of reforms advanced gradually, creating flexibility and momentum for further market reform. Regarding the *ex post*

¹⁴ A interesting discussion about the importance of the state can be found in Kornai (1990: 57-80)

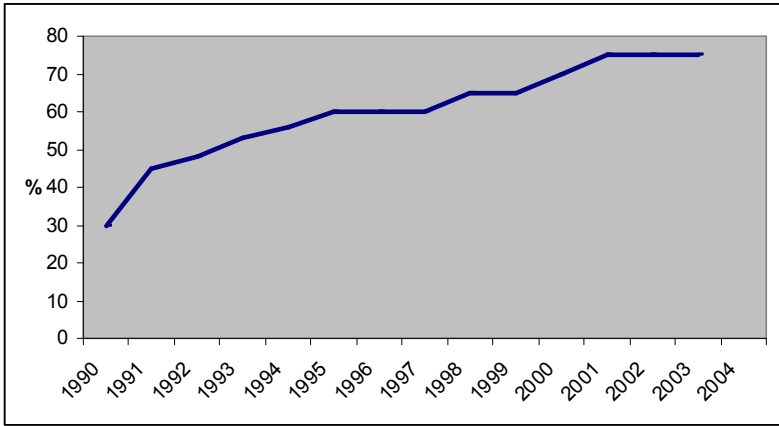
constraint, these were circumvented by establishing reforms that were fundamental to the market environment. Reversibility could not occur since the reforms constituted the basis for the market economy. Therefore, by establishing a solid institutional framework characterised by continuity and fairly secure property rights, the private entrepreneurs were given incentives to operate on the Polish market.

4. Conclusion

The purpose of this study has been to compare the relative effectiveness of, on the one hand, the Evolutionary approach and, on the other hand, the Washington consensus in promoting a dominant private sector, employing the Polish privatisation process as an illustrative example. In addition, the study has also envisaged evaluating the outcome derived from the privatisation program.

The outcome of the overall privatisation process – both ‘from above’ and ‘from below’- has been extraordinary. The positive outcome from the privatisation program is illustrated in figure 5. During the last decade, Poland has experienced a continuous increase in the private sector share of GDP. The initial share of 30 per cent in 1990 has increased to 75 per cent in 2004, thus accentuating the pivotal role of privatisation in creating a strong and vital private sector. Irrespective of privatisation method, the Polish case demonstrates how rapid the shift from a state controlled economy to a free and private controlled economy has proceeded. Consequently, the first aim of privatisation- to separate the SOEs from state control and create a dominant private sector- is in effect fulfilled.

Figure 5, Private sector share of GDP, 1990-2004



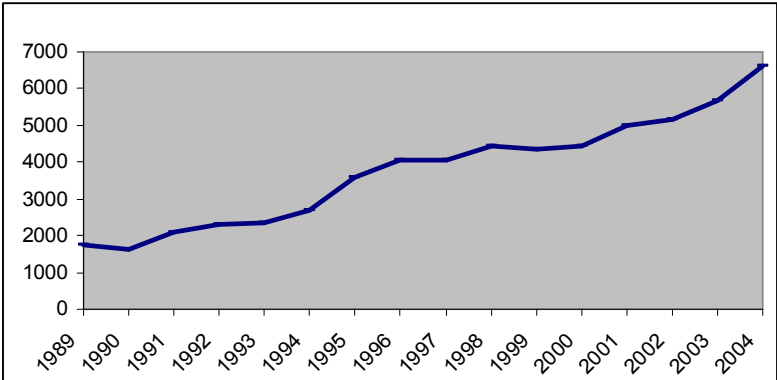
Source: World Bank¹⁵

In addition, the privatisation process- pictured from a macroeconomic perspective- has had substantial effects on the overall enrichment of the Polish population. According to IMF data, the growth in per capita income has been relatively high and resulted in the ‘embourgeoisement’, deemed as particularly important by Kornai (1990) in the creation of the

¹⁵ <http://www.worldbank.org/ecspf/PSD-Yearbook/poland.html> and <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES>

sustainable development of a strong and vital sector. From figure 6 (50), the GDP per capita development is exposed. After years with slow economic progress due to the macroeconomic imbalances, the GDP per capita has been characterised by a strong growth. This was due to the fact that the GDP growth conceded with the overall adjustment of the Polish economy through the implementation of the stabilisation and liberalisation program, enhancing the emergence of *de novo* firms in the economy. Although the stabilisation and liberalisation program resulted in the contraction of GDP, it entailed essential reforms for the continuation of the privatisation process. From that, this study has developed insights through extensive research, supporting the positive efficiency effects from the growing share of *de novo* firms in the Polish economy. Furthermore, this study supports evidence of the notion that high inflation and GDP growth are negatively correlated. This is exemplified by the stabilisation of inflation and the momentum phase for GDP growth where the GDP per capita augmented significantly (compare with Figure 2: 32).

Figure 6, GDP per capita Development (USD), 1989-2004



Source: IMF Economic Outlook

This study has illustrated that the initial conditions played a significant role in the transition process as a whole, but specifically in the privatisation process. The economic austerity program introduced in the 1980s forced the Polish economy to make important steps in liberalising the economy and this resulted in the slow (re)emergence of formal and informal norms- compatible to the new conditions of the market economy. As these norms were redeployed in the mind of the Poles, it facilitated the shift from a socialist economy to a market economy. As a result, this progress provided indicators for the direction and the outcome of the privatisation process.

The implication of the political change on the privatisation process was manifested through the strengthening powers of the SOE insiders. This produced a strong opposition to the privatisation 'from above' method and- together with a general political constraint- the cause to the Washington consensus-approach's disappointment in Poland. The rapid transformation of the SOEs was never materialised and the MPP- synonymous with rapid privatisation- played an insignificant role in the privatisation 'from above' process. However- and in contrast to the theoretical predictions made prior to reform- the indirect privatisations played an important role in privatising the SOEs, and this, by reducing the state control over the economy and generating substantial revenues to the state, thus satisfying the third aim of privatisation and reinforcing the first aim (see 2.1: 8). The privatisation through the IPO schemes gained momentum throughout the 1990s and concurred with the stunning development of the Warsaw Stock Exchange (WSE). However, as this study has illustrated, this progress was sluggish and was not the explanation behind the extraordinary development of the private sector during the studied period.

This study has identified the organic growth of *de novo* firms as the driving force behind the emergence of the private sector in Poland. These firms met the second aim of privatisation; enhanced productivity, thus stating the relative efficiency of this form of privatisation. The *de novo* firms adopted the behaviour of the economic agents in market economy by internalising cost and allocating their resources in a more efficient way. From that, this result is to large extent derived from the market environment in which they operated in. The theoretical assumptions made in section 2 (a hard budget constraint, competitive markets, property rights and macroeconomic stability) have proved vital in the creation of a market environment favourable to the emergence of a private sector. An additional explanation to this outcome is derived from the circumvention of the ex post constraint (reversibility). While the privatisation 'from above' was exposed to a hostile political and popular opinion, the Evolutionary approach introduced fundamental conditions for the market economy which surpassed the general resistance from the population, thus lowering the risk of reversibility substantially and further indicating the success of the Evolutionary approach over the Washington consensus.

In addition, the surge of entrepreneurs following the fall of the Communist regime and the initial inauspicious market conditions substantiate the force of the private economic activity in Poland. This 'force' was allowed to gain momentum through the reform enacted in the

stabilisation and liberalisation program. From that, the success of the Evolutionary approach relies in the creation of an institutional setting favourable to a market economy, which has been generated by the market environment reforms. Consequently, the foundations for an incentive based economy have been laid. The Polish case shows evidence of the relative effectiveness of the Evolutionary approach- in promoting a dominant private sector- over the Washington consensus-approach.

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