Working Paper

Small Scale Privatization in Eastern Europe and Russia from a Historical and Comparative Perspective

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WP-92-067
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Foreword

This Working Paper is a summary of a workshop which was held at the International Institute for Applied Systems Analysis (IIASA), Laxenburg, Austria on 26–28 June 1992.

Small scale privatization (SSP) of shops, restaurants and other consumer services has been accomplished in the first stage of the complex process of privatization in Eastern Europe. It was also an experiment for measuring the demand for previously state owned property and for verifying different techniques of privatization. The Russian Federation is now undertaking the first steps in SSP and may learn much from recent experiences of the other East European economies. In order to facilitate such an exchange, a workshop was organized at IIASA to analyze the pattern of SSP in the Czech and Slovak Federal Republic, the former East Germany, Hungary, Poland, and Russia. The characteristics at each stage of the privatization processes were thoroughly discussed and compared across the nations, beginning with the emergence of the idea of SSP, through legislation and the rise of unexpected tensions during the implementation phase, to the characteristic features of newly privatized retail and service businesses.

Sincere thanks go to all the scientists and policy experts who contributed greatly to the success of this workshop. It proved to be both a unique and useful intellectual exchange regarding a very practical issue, especially for those nations with substantial privatization still to be undertaken. Gratitude is extended to the Japan Foundation for its financial support of this venture.

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1. Introduction

Small-scale privatization (SSP) is an integral part of the transition to a market economy in the economies of Central and Eastern Europe (CEE) and the Russian Federated Republic (RFR or Russia). Throughout these nations a predominant hope has prevailed that SSP would constitute the fastest, easiest and most welcomed part of the complex privatization process and additionally serve as a catalyst for the development of a wide cohort of entrepreneurs. These virtues of SSP were expected to be a major contribution to the evolution of competition, the unfolding of a market economy and the balancing of the hardships the population must endure as a consequence of the crisis accompanying the process of transition.

While small scale privatization is still in its very infancy in Russia, it is well under way or close to completion in the former socialist countries of the neighboring West. The smaller East European economies differ in terms of their initial conditions, privatization legislation, techniques employed in SSP, the level of public content with the results of SSP, and other factors. Consequently the study of these issues could be beneficial for the advancement of SSP in the Russian Federation.

The potential to benefit from and assess the applicability of the experiences of Central and Eastern European countries motivated the Committee for the Management of State Property of the RFR to ask IIASA to organize a workshop that leading officials from the responsible agencies for SSP from these smaller countries would attend. As a result, top officials and experts from the Ministry of Privatization of Poland, the Ministry of Industry and Trade and the State Property Agency of Hungary, the Ministry of Administration and Privatization of the Slovak Republic, German, Polish, and Hungarian economic research institutes, and IIASA gathered in Laxenburg in late June 1992. They met with the department chiefs from the Russian Committee for the Management of State Property of the RFR designated by Anatoly Chubais, Deputy Prime Minister of the RFR and Chairman of the Committee.

The meeting was characterized by a very open exchange concerning the individual nations' experiences in small scale privatization. The combination of leading policy-makers with hands-on experience and research scholars specialized in background material and analysis of results proved to be a useful mix of participants in an effort to achieve the balanced perspective on the topics of discussion.

The accounts of the various national experts and ensuing discussions together form the intellectual basis for this up-to-date description of SSP in the CEE countries and Russia. The information we collected during this workshop has been complemented with background material (refer to the references) and with the information the authors acquired on their study trips to Budapest, Prague, Moscow, and Warsaw during 1991-1992. We wish to thank all the participants of the workshop for their valuable contributions. Their names and positions are listed in the Appendix. Other contributions notwithstanding, views or opinions expressed herein are solely those of the authors and do not necessarily represent those of the International Institute for Applied Systems Analysis or of its National Member Organizations. Any omissions or errors remain those of the authors.

The structure of this report more or less follows that of the workshop. Each session provided information on the particular topic of SSP on the agenda in each East European economy and Russia. The purpose of this organization is to facilitate a representative account of the progress and effects of SSP in the various nations and to finally summarize the relevant experiences for a nation just embarking on this simplest form of privatization.

2. Emergence of the Idea of SSP - Principles, Legislation and Techniques of Small Scale Privatization

2.1 The Czech and Slovak Federal Republic

SSP legislation was approved on 1 October 1990 (The Law on the Transfer of State Property and Some Goods to Other Juristic or Natural Persons). The legislation defined small scale privatization by two features: the business to be privatized would not carry on any obligation of the previous owner (debt, other obligations like training apprentices, etc.), and the only method to be used was to be the auction. The legislation did not define the maximum value or activity of a particular unit to be privatized under SSP. Thus, any type of retail, wholesale, and even manufacturing enterprise could have been privatized under the guidelines of the SSP program. The largest items sold in the course of Czechoslovakian SSP exceeded a value of CSK 100 Million (USD 3-4 Million).

The auction was seen as the most transparent method for unbiased distribution. It allowed some adjustment if the original assessment of the value of the unit to be privatized turned out to be unrealistic. The auction was also regarded as a method that was most infallible in terms of corruptibility.

The ultimate decision power in SSP was in the hands of the Ministry of Privatization. Privatization commissions were formed in every district, in Slovakia for instance there were 38 such districts. Each commission made a list of businesses to be auctioned. The municipalities and local governments were advising on the inclusion or exception of particular businesses. The managers of the business were obligated by law to make all the necessary data regarding the enterprise available within 30 days. After the lists were discussed with the local authorities and branch ministries, the Ministry of Privatization had to give final approval. The commission was responsible for publishing the list in mass media at least 30 days before the auction. Auction participants were required to pay a fee for participation and a deposit refundable 10% of starting price or CSK 10,000 (USD 300-350) to take part in the auction. The price determined in the auction had to be paid 30 days thereafter.

During the preparations for the SSP some general principles were followed to preclude the emergence of a monopolized private retail trade. Giant retail trade companies responsible for the supply of whole counties were split up to several smaller units, while wholesale activity of these companies was concentrated to one of the new units created from the old company.

The basis for small scale privatization in the CSFR did not rest on the goal to achieve the highest possible price or returns from SSP. The true objective was simply to reduce state ownership and to create an indigenous business class. This is why legal persons founded in the previous socialist system (like state owned enterprises) were precluded from participating in the auctions and also foreign (physical or legal) persons were allowed to enter in the second round of auctions only, that is, if the first auction for a given unit turned out to be unsuccessful.

Auctions were carried out by independent committees. The auctions were divided into two groups depending on the character of the items:

1. The whole entity, including land and buildings; and
2. Enterprises located within the building, that were not the property of the building owner. In this case, the inventory and equipment was auctioned, not the level of the rent. The winner of the auction had then obtained the right to make an agreement with the owner of the building for two years (in October 1991 extended to an obligatory five years) rental agreement.

If the auctions were faced by a lack of demand, then the law allowed the modification of the auction to the *'Dutch-clock'* form, in which the initial price could be successively reduced. In the first round prices could be reduced to 50% of the original price by increments of 10%. In case the first round did not result in a sale, a second round followed in which prices could be allowed to decline to 20% of the original price. The only limiting condition for a Dutch-clock auction was that at least five persons had to take part in this event. Out of the 15,000 to 19,000 auctions in the process of SSP, about 1500 had to be concluded through the Dutch manner.

Tradition made it difficult to determine the appropriate method to identify the most reasonable calling price. Originally, the depreciated value of buildings and equipment was simply used. The distorted pricing system under communism rendered this system as inadequate. In May 1991, a special decree was passed on how to compute the prices of businesses. Two multiplier coefficients, based on the original price of buildings and machinery and on the year of privatization (the age), were used. After some months, the coefficients were thought to be too low, leading to their increase in late 1991. This intervention later turned out to be excessive because the price of real estate was then above the market value making it difficult to sell.

The revenue from SSP is kept separate from the state budget for anti-inflationary reasons. In the one and a half years before June 1992, 14 billion Krones were earned as a result of privatization. Some of these revenues have been used for the privatization process.

During the preparation of the privatization law many employees of *to-be-privatized* enterprises requested exceptions and special preferences. The request for closed rounds of auctions, restricted solely to employee participation, was one of the most popular among them. As for additional pressure, trade unions threatened with industrial actions and strikes. While the governments were divided on the issues, eventually both the stronger part of the three governments (ministers of economic affairs in the Czech, Slovak and Federal government) and the Parliament rejected the granting of any preferences for the employees of the units to be privatized in the SSP.

2.2 Former East Germany

After World War II, East Germany was still a center of flourishing private enterprise, particularly in retail trade, services, and light industry. In 1950, this sector employed 42% of the work force and accounted for 31% of GNP. However, by the early 1970s it had, for all intents and purposes, been eliminated. Most of the small and medium sized businesses had been absorbed into the oversized administrative, integrated enterprise organizations called *Kombinate*. In 1989, the private sector produced only 3% of GNP, but was still most active in retail trade and services.

We need not emphasize that the German process of privatization is a very special one. The legislation that was required to facilitate the realization of SSP was essentially a function of the unification process of the two Germanies in 1990. Firstly, this encompassed the monetary union with West Germany and the acceptance of the general laws and business practices from West Germany, and secondly, the establishment of the trust agency called Treuhandanstalt. The Treuhand was actually established by the still communist government on 1 March 1990 as a trust company and was transformed to a state holding company to manage and ultimately privatize state property by a modification of the first law on 17 June 1990.

Initially all state property was transferred to the Treuhand, which in turn changed the existing enterprises to either joint stock companies or limited liability companies. After dealing with some complications involving restitution problems, a speedy SSP program was introduced.

Restitution was a major obstacle for East German privatization. Privatization was seriously hindered by unresolved problems of restitution until late March 1991 when the so-called *speed-up law*, which modified 11 existing laws, 130 regulations, and a new law and 62 new regulations were introduced. These new regulations made it possible to compensate previous owners by cash rather than by original property.

In the area of the former German Democratic Republic the decisions to put property up for auction were made by commissions. These commissions were made up of local government persons, other state officials, and members of the Treuhand.

The Treuhand was dealing with all properties of the 126 giant *Kombinate* (integrated enterprises containing small and medium-sized firms) and over 2,000 retail enterprises belonging to local authorities. Generally, the SSP was undertaken by regional offices of the Treuhand, while only the largest units were handled by the head-office.

The privatization actually could proceed top-down and bottom-up. The latter method was facilitated by the introduction of the so-called *"Split-up Law"* (division of vertically integrated enterprises into profit centers), while the former was operationalized by the establishment of as many as 5,000 boards of directors consisting mostly of West German managers. This process created the units for small-scale as well as large-scale privatization. After privatization, Treuhand guarantees loans to new enterprises and aids in financing with banks.

Competitive (sealed) bidding campaigns (also referred to as investment contests) were organized for shops up to 100 m^2 and restaurants/pubs up to 160 m^2. These competitions were published in regional and inter-regional newspapers only one week before the auction. The purpose was to indirectly restrict access to outsiders. (There were no direct restrictions on foreign or West German capital in place.) As a consequence, 80% of the businesses were sold to native East Germans. In the service sector, though, many services were simply taken over by the communities (i.e., transportation, health care facilities, etc.). In the process of SSP, the task and obligation to take over the type of activity and maintain the existing employees were transferred to the new owner.

2.3 Hungary

Until the end of the 1980s, retail trade in Hungary was characterized by a dominance of large trade networks owned by the state or cooperatives. They were in a quasi-monopoly position on the markets of certain product groups or in certain regions.

In spite of these networks, the importance of private shops also grew most significantly during the last decade. By 1990, the share of private shops reached 56% in terms of the total number of shops and 20% in terms of total retail trade turnover. The number of private trade companies also radically increased: by 1988 their number was almost 3,000 and their share in the total trade turnover was 1.5%.

On the initiative of the government, a great number of outlets of the large retail trade networks was contracted out or leased to private entrepreneurs from the early 1980s onward. This system had several advantages; namely, as a consequence of the profit-motivation of the renters the supply of products in the shops and the level of their services improved. However, the strange situation developed that a growing part of the revenues of the state owned trade networks originated from the rents paid by the entrepreneurs. The centers of many of these networks seemed to become sheer parasites, collecting an additional rent over the one that had to be paid to the owners of the premises, the local authorities. The system reached its peak in 1989, when the trade turnover of the shops in leasing form (contractual or rented) exceeded the turnover of the shops, functioning in traditional form.

The inefficiency of this system sooner or later gave rise to the idea that the original companies should be abolished by splitting up into shops and so enabling the potential entrepreneurs to rent the shops directly from local authorities.

By officially discussing this idea, Hungary was, in fact, the first of the small Eastern European countries where SSP was put on the agenda of economic reform. However, for different reasons, Hungary's program turned out to be the least ambitious and the tardiest in the region both in its objectives and its implementation. The reason for this partly lay in the substantial and growing private sector in Hungarian retail trade and services by 1989.

In 1989, the original idea of the SSP led to much controversy. The major argument against it, expressed mostly by managers having vested interest in the old form of state retail networks, was that cutting the networks into pieces would put the shops into a defenseless position *vis-a-vis* their suppliers, the huge state industrial enterprises.

The SSP law was finally adopted in August 1990, entered into force at the end of September, and the program actually started at the end of that year. One of the reasons why this SSP law was eventually adopted and called the Pre-Privatization Law (indicating the type of privatization that must precede other privatization programs) was the recognition of both the government and the deputies of parliament that without an urgently needed immediate step forward, wild and spontaneous privatization would make SSP soon meaningless. As a matter of fact, between the summer of 1989 and August of 1990, in the phase of the so-called spontaneous privatization, several huge trade companies were transformed into limited liability companies and formed joint ventures with foreign companies. Many of the managers of these state companies made major efforts to arrange a very rapid - complete or partial - transformation of their company because they feared that the introduction of the SSP would lead to a break-up of their original firm. This run for transformation - based on other laws like the Company Act, Act on Foreign Investments (both of 1988) and the Transition Act (1989) - meant that by the time the SSP program started, a great number of shops no longer conformed to the definitions of the SSP Law. In fact, many of the most valuable shops were already sold, and the ensuing revenues had been invested in a way the state could not make use of them anymore.

The SSP law put the SSP program under the control of the State Property Agency (SPA). This law covered businesses, workshops, and consumer related services functioning already on lease or on other contractual basis. *'Small scale'* was defined by the number of staff, not exceeding 10 in retail trade outlets and less than 15 in catering trade establishments. In the case of hotel trade, consumer related services and petrol stations, small scale was defined by a limit regarding the turnover of the unit.

The units were to be sold at auctions: the initial price had to be determined by the SPA. The price was the main and only criteria of winning in the auction.

The general principle of Hungarian privatization practices is the sale of businesses for real values rather than giving them away for free, even at the expense of more rapid privatization. While this principle has been challenged many times in the last few years, modifications of the procedures helped only a little in speeding up different programs of privatization. One such recent modification in SSP, which we will elaborate later, reveals the possibilities for a major group of shops to avoid auctioning.

There are no conditions in the privatization program that call for granting preferences of previous leasers or employees of the outlet, except for a minor qualification in case of equal bidding, the previous leaser and employees enjoy priority.

In an effort to speed-up SSP, Hungarian policy-makers decided early that claims for full restitution of previous owners will not be entertained. The principle of compensation that was accepted by the parliament much later than the SSP law (namely, in the middle of 1991) states that previous owners are compensated for their nationalized property to a certain extent only with and in the form of bills of restitution. These bills can be utilized in limited ways, bidding for outlets in auctions included.

In some cases (in the case of food-stores, bookstores, etc.), the new owner/renter had to guarantee that the profile of the shops will be maintained for a certain period of time. In the majority of cases not the ownership right, but only the right to rent for 10 years was sold. Outlets covered by the SSP could only be sold to Hungarian citizens, foreigners were not permitted to take part in the auctions.

The legislation also permitted retail outlets to be auctioned several times. An auction is defined as unsuccessful if the expected value determined by the State Property Agency is not reached. In such a case, the unit would be re-auctioned in a so-called *simplified auction*, to which only the most serious bidders are invited.

2.4 Poland

After 1947, the communist takeover effectively suppressed and destroyed private retail trade and consumer services in Poland. This major event of Polish history had reverberations throughout the next forty years as reflected in the waves of centralization and decentralization of trade; the last minor decentralization campaign being initiated in 1981.

The private sector's share in Polish retail trade, however, started to increase substantially only in 1989, before the wave of SSP. This growth was partly a response to liberalization measures making it possible for citizens to start new businesses and partly a reaction to the huge shortages of consumer goods in state shops. The number of retail trade outlets jumped to 72,000 from the previous year's 43,000, not to mention the tens of thousands of unregistered vendors conducting business in city streets and squares.

Small scale privatization of existing state outlets started in early 1990 and gained a momentum in the middle of that year. SSP in Poland has not been guided by a single, specific act. Accordingly in order to understand the pattern of events one must refer to several acts, as well as to the major turn in macroeconomic control and economic policy initiated in Poland early January 1990.

Polish SSP refers to those 100,000 businesses, mostly shops and consumer services, wholesale and retail trade enterprises where the founding organ was typically the mayor or the municipal council of the locality. The legal status of these municipalities was formed by three major events in 1990. First, free local elections were conducted on 27 May. Second, on the same day municipalities obtained a legal identity and limited financial independence. They were also granted the property rights over business premises (land, building lots, shops, restaurants, apartments) as well as those of about 1,600 companies. This meant that the long-standing agreements between the owner of the space (most frequently the community) and the user (one of the several hundred large enterprises) had been canceled. The owner of a building, the local authorities, could then independently decide and negotiate with potential renters. The third important event was the *"Act on Local Self-Government"* adopted in May 1990. This bill finished the formation of an independent local owner capable of initiating and controlling a fully decentralized process of small-scale privatization.

In fact, this is the most important characteristic feature of the Polish SSP: the extremely decentralized and unregulated manner that was coupled with a relatively fast pace of the privatization.

Two additional laws enhanced the unfolding of the small scale privatization process: the *"Act on Economic Activity"* (effective early 1989), and the *"Housing Act"* (June 1990). The first of these two acts granted the right to set up a business for each citizen without the need to obtain special permits or licences, while the second excluded trade outlets, like shops from the special renting mode in which rents had been set centrally, by the Council of Ministers.

In addition to this legal framework the federal government only made recommendations on a limited basis to the local authorities in charge of privatization. This lack of central control resulted in a remarkably large variation of how local authorities arranged the privatization of the outlets they had possessed. Even if some regularities have emerged in the process of privatizing the several tens of thousand of outlets under the auspices of the 2,700 municipalities (like the overwhelming dominance of lease privatization over outright sale or the scarcity of unrestricted auctions), these were more the result of implicit legal constraints or social relations than of any explicit central regulation or directive.

2.5 Russia

Russia is a unique nation in many ways. In Russia, there is practically no living memory of small entrepreneurship as there was in the other Central and East European economies. Private trade was virtually eliminated in Russia a quarter of a century or more before it was done in the other CEE nations. Correspondingly, central distribution has its deepest roots in Russia. One of the greatest obstacles to the implementation and success of small-scale privatization in the RFR is a direct result of the aforementioned factors; namely, the psychology of the population.

The actual process of small scale privatization began in early 1992. Although several occasional auctions were registered in various parts of Russia during 1990-1991, since then the process was chiefly motivated, initiated and directed by the central government of the Russian Federal Republic (RFR). A number of decrees signed by President Boris Yeltsin since November 1991 had facilitated the key breakthrough to realizing privatization procedures. These included:

"Foundations of the State Program of Privatization for the Year 1992";
"On Commercialization of Trade";
"On Commercialization of Consumer Related Services"; and,
"On Freedom of Trade".

In addition, the Supreme Soviet (Council) of the RFR had passed the act *"On Separation of State and Municipal Property"* on December 27, 1991. This decree was essential for the reorganization of trade controlled by large industrial ministries and opened the door for regional privatization committees to actively begin privatization. Since then, small scale privatization became fully legitimate and received true legal status in Russia and, more importantly, the strong support of central authorities.

In late 1991 and early 1992, the start of commercialization[1] and the ensuing liberalization of retail trade created an appropriate environment for the beginning of mass small scale privatization. In fact, until as recently as the middle of April 1992, half of the retail trade and consumer related services outlets in Russia were still not commercialized. In addition to possessing no separate assets, balance sheets, or bank accounts, these outlets were also not legal entities[2]. At that time, between 40% and 60% of all retail trade and service outlets in Russia were still exclusively the property of one or another of the large regional trade monopolies. There had been 1,800 of these vast organizations in Russia, entirely controlling supplies, stocks, distribution, sales, finances and accounting of their retail branches.

Among those outlets already commercialized, most are small and still largely depend on their former *'parents'* due to the generally high level of monopolization of supply, storing and transport networks, not to speak of the inexperience of personnel and the infancy of banking infrastructures. Nevertheless, *'the ice was broken'* and since then millions of people have tasted the spirit of small entrepreneurship as either consumer or sales agent.

Mass small scale privatization in Russia officially began on 5 April, 1992, when local authorities successfully auctioned over 20 cafes, shops and other commercial retail outlets at the first regular auction in Nizhny Novgorod[3]. The International Finance Corporation, the private sector arm of the World Bank Group, has drawn from the lessons of Central and East European countries in order to design a unique privatization project in Russia's third largest city. Experts from Poland and the CSFR joined the international team. The plans were to sell 2,500 of the city's retail trade and services operations by the end of this year.

[1] Commercialization refers to an enterprise achieving the status of being financially and managerially independent. This definition, used by the International Monetary Fund (IMF), also best corresponds to the meaning of the term in Russian.

[2] One must register to become a legal entity in Russia, otherwise one is considered a physical entity. The procedure is fairly complicated and time consuming.

[3] This city had been more commonly known as Gorky in the past. During the transition, it regained its historical name. According to the old Russian tradition, people often refer to it as Nizhny (meaning *'lower'*).

In an effort to equalize the vastly different rates and breadth of SSP among alternative regions, Russia was divided into 88 regions and a regional privatization committee was established in each one. In the initial phase of SSP there had been no true links between the central and the 88 regional committees. Due to inadequate results in the distribution, amount and speed of privatization, which was in part attributed to the lack of active ties between the regional and central committees, the former were subsequently directly subordinated to the Committee for the Management of State Property of the RFR in Moscow. Further reasoning behind this move was as a result of the premise that, in Russia today, the central government is acclaimed to be more progressive and reform oriented than the local authorities and committees. It is not too surprising that this has resulted in a very hierarchical structure, but the Committee has argued that the necessity for this lies in the need to speed up the process and reduce the influence of local *'apparatchiks'*.

According to the legislation, start-up prices of outlets are set at their book value in 1979 prices. As a consequence, and additionally due to the extensive investors' interest, selling prices of outlets were many times higher than the start-up prices.

All over the country, an instance has yet to occur in which a foreign investor has bought outright a retail trade or services enterprise, despite the large number of foreign firms leasing hundreds of premises for retail trade, mostly in Moscow and St. Petersburg. Yet, present leasing agreements of these foreign firms do not automatically give them the rights to buy outlets once the leases expire. The participation of legal and physical entities from other republics of the former Soviet Union has also been very weak, although generally these people are not yet considered to be foreigners.

Small scale privatization is not hindered by claims of restitution in Russia, as has been the case in most of the smaller Central/Eastern European nations. In Russia there are no grounds for restitution. Previous owners and their descendants died long ago, documentation was discarded and buildings were ruined. All over the country, only a few claims of former owners were registered, but none were even considered in a court of law. The legislation does not preserve the rights of former owners.

On 5 June 1992, the Supreme Soviet of the RFR modified the one year-old law *"On Privatization of State and Municipal Enterprises in the RFR"*. As far as small scale privatization is concerned, auctions have become the dominant accepted procedure permitted for the sale of both insolvent and well-functioning enterprises. This should effectively put a halt to giving away enterprises to employees, which has become an all too popular strategy in several regions. The new version of the law also includes a package of anti-monopoly measures: for instance, it forbids mergers and acquisitions in the process of privatization, as well as termination of earlier existing legal entities. The changes have significantly strengthened the legislative power of the Committee for the Management of State Property.

On June 11, the Supreme Soviet of the RFR has accepted *"The State Program of Privatization for the Year 1992"*. This document has been issued within the framework set forth by Yeltsin's half a year old decree on the *"Foundations of the State Program of Privatization for the Year 1992"*. The Program has not only confirmed mandatory privatization of the entire wholesale and retail trade and consumer related services in as short a period as feasible, but also included in this list units that currently belong to industrial ministries and large state enterprises[4].

The other important novelty in the program is that small enterprises with less than 200 employees and a book value on 1 January 1992 (in 1979 prices) of less than 1 million rubles can only be privatized via the auction method at this time. This attaches the quantitative criteria to the corresponding article of the legislation. While it may seem obscure the absolute majority of not only retail but also wholesale trade outlets satisfy these criteria.

According to the estimates provided in the Program, the gross revenues of privatization in 1992 (including large scale privatization yet to be started) will reach approximately 74 billion rubles, including 15 billion rubles from physical entities and 10 billion rubles from foreign investors. The Committee for the Management of State Property expects to essentially complete small-scale privatization in Russia by the middle of 1993.

According to *"The State Program of Privatization for the Year 1992"*, the following techniques of privatization are recognized:

- auctioning of enterprises;
- investment contest with binding conditions (with mandatory competitive bidding at an auction)[5];
- non-commercial investment contest with regulated access[6];

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[4] Industrial ministries and large state enterprises directly own almost 100% of retail trade and consumer related services in certain areas, such as oil pumping and coal mining regions, metallurgy, and nuclear energy centers. These ministries and enterprises must now sell off their free-access retail shops and service units by the end of this year. The only exceptions are the shops located at oil wells, gold mines, and other very inaccessible locations.

[5] The binding conditions include one or (rarely) more of the following three:

1. preservation of the former type of business,
2. perpetuation of the employment of the persons previously working at the outlet or enterprise, and
3. obligation to invest.

Such a contest is arranged primarily in rural areas and small cities, where the profile of the retail outlet is important for the population. The only participants allowed to bid are employees of the enterprise to be sold and residents (physical entities) living in the vicinity.

[6] The only participants permitted to enter such a contest are those who are ready to provide necessary financial injections. The winner might not be the highest bidder, but the one who best satisfies the criteria of the competition.

- auctioning of liquidated or insolvent enterprises;
- buy-out of earlier leased property (without competitive bidding); and,
- sale of shares of open joint stock companies.

In addition to the first technique on the list, which has been the most frequently utilized instrument, the other privatization techniques have also begun functioning to a varied extent throughout parts of Russia. Since the bankruptcy legislation has not began to work on a full scale, there is not a large number of insolvent enterprises on sale yet. An investment contest is technically very difficult and time consuming: this explains its relative lack of popularity. In contrast, the buy-out of earlier leased property is very popular since, back in 1990, a large number of retail and even wholesale trade enterprises became leased companies.

The parties permitted to enter auctions and contests are:

- physical entities-residents[7];
- legal entities-residents[8], if government share in their property does not exceed 25%;
- any foreign investors if there is consent from the local Soviet (Council).

In general, new owners are not burdened with legal handicaps, but they simultaneously receive little guaranteed benefits. Only in some special cases, as employee buy-outs, are there some regulated privileges for buyers. According to the law, the employees are required to pay only 20% of the clearing price immediately and the rest on a three year installment basis negotiated by the parties upon sale. They also get a 30% reduction in the price of the lease which is deducted from the eventual selling price.

If auctioned property belonged to local authorities (the most prevalent case), almost all proceeds go to the local budget with two exceptions: 4.5% of gross receipts are collected by the Committee for the Management of State Property and another 10% go to the federal budget.

Russian and foreign banks are free to finance would be investors, but they cannot use the Central Bank of Russia credits for such purposes.

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[7] Although the status of citizens from other Republics of the former Soviet Union remains unclear; in most cases, they are allowed to participate by default.

[8] Again, the status of the residents of former Soviet Republics remains unclear. In small cities and in rural areas, these *'foreign'* residents normally find it extremely difficult to bid due to the obvious social and political constraints. However, organizations from former Republics of the USSR have widespread operations, for example, in the Moscow real estate market.

3. The Progress of SSP - Major Problems Emerging in the Process of SSP and Thereafter

3.1 The Czech and Slovak Federal Republic

Privatization of the retail network began 1 January 1991[9]. Small-scale privatization coincided with the start of economic deregulation. As of the beginning of 1991, retail stores had no central orders to fulfill regarding sales or supplies as directed from the state or local governments. Very few of the large state retail enterprises were under ministerial jurisdiction by this time, most were under local or regional authority. From this point onward, prices, inventories, and sales policies were solely the responsibility of the individual retail outlets.

Originally, the SSP in the CSFR was a grand scale and fast program of privatization. Approximately 100,000 to 120,000 units were to be privatized in a short period of time, but in the middle of the period assigned for the SSP (in October 1991) the Czech Minister of Privatization declared that there would be no more that 23,000 units privatized in the program. The cause of this change was manyfold. A large amount of the shops and services were not capable to be offered for small scale privatization because of the condition of making them free of previous obligations. Many of the shops offered at auctions did not turn out to be as attractive for would be buyers as they were originally conceived.

Special rules for restitution (a full in-kind compensation of previous owners) also hampered the sale of many shops: the deadline for claims regarding previous property is the end of 1992 and the highest estimation for the percentage of the total number of retail trade shops to be claimed is 40%. According to the principles applied here, restitution had priority over SSP. No entity could be singled out for privatization if there were any hints of restitution claims on hand or to be expected.

The retail and service outlets that did not find new owners as a consequence of SSP (or original owners through restitution) were not to remain untouched: these will either be privatized in the framework of the large-scale privatization (now complemented with their obligations) or will be liquidated.

Even if the original number of units had to be scaled down, the SSP in Czechoslovakia was a relatively fast process. In Slovakia for instance over 85% of the (scaled down) number of units had been privatized by 21 June 1992, either via auction (67%) or as part of the restitution program (18%). If numerous retail stores under the authority of communities or cities are included, the percentage

[9] The network consisted of approximately 8,000 retail shops: 4,500 food, 3,000 non-food, and the rest were big department stores and mixed shops.

is even higher. At any rate, the SSP process by auction should be completed by 30 June 1992.

Small-scale privatization has contributed to and stimulated the emergence of the private sector. The importance of this sector in the whole economy has expanded dramatically. In Slovakia, the share of private sector sales revenue quadrupled during 1991 and reached 46% of total volume in the first quarter of 1992. Slovakia has gone from having virtually no private sector in 1990 to having a full-fledged private sector in retail, services, and some manufacturing by June 1992.

The structure of ownership after privatization appears to be quite widely distributed. Many of the new owners consist of former employees who were successful in the bidding competitions. This, however, is not the majority. Numerous persons previously outside the retail trade and services sectors have become new owners. This has been very favorable for the development of the private sector and competition because these new people are thought not suffer from decades of enduring existing practices in the business.

Early in the SSP program, much of the old *nomenclatura* and many enterprise managers attempted to purposely slow the process by not providing local privatization commissions with the required statistical basis needed to determine an enterprise's privatization fitness. Therefore, guidelines on the compulsory provision of enterprise data had to be entrenched in the privatization legislation.

While few have questioned the method of auctions as the most appropriate way of privatizing small business, the fairness and efficiency of the implementation have often been the source of controversy. One sensitive question was the hidden participation of foreign capital. Many foreign investors did not want to wait until the second round of auctions by leaving the best objects for those eligible for the first round. Instead, they participated in the first round as silent partners and have thus acquired many units, the number and value of which is still unspecified. These illegal actions were facilitated by some loose regulations: the buyer did not have to justify the origin of the money (many times millions or ten millions of CSK) he paid for the outlet, nor the fact whether the source was taxed revenue. Another point of concern was the practice of Dutch-clock auctions, where the law could not prevent collusion between the participants and accordingly many such auctions were judged as unfavorable by the public.

Peaks and troughs quite clearly characterized the prices achieved for outlets at auctions in the CSFR over the last 18 months. In the early months, growth in prices was low due to caution on the part of buyers and the unfamiliarity with entrepreneurship. Just as prices were rising, a new decree to set higher starting prices caused demand to drop. Prices gained momentum, only to be suppressed again by *quasi-legal* actions of corrupt forces and racketeers. Government measures to combat corruption led once again to higher prices, but measures regulating the calling prices caused SSP to slow down and gains to decline considerably towards the end of the 12 month period.

Selling prices of the outlets were initially 50% to 60% above the initial prices; the average realized selling price being around CSK 1 Million. In 75% of the cases, only the right to rent the outlet was sold, and it was mostly these cases where selling prices were much higher than the initial ones.

As for the post-privatization activity of the shops, the first experiences show that the supply provided by the privatized units have often diverged from the standard selection and supply of goods known in the past. This has created particular problems in meeting the demand for industrial products where former standards are still the norm. The very rapid dismantling of the retail network to many different entrepreneurs has not guaranteed the preservation of the distribution system as it was, resulting in a shortage of certain goods. On the other hand, the new additions to the selection are usually very similar in most non-food retail shops; namely, imported toys, electronics, perfumes and other household chemicals, consumers goods, and so forth.

Another interesting feature of the renewed activity of retail trade has been provoked by restrictive macroeconomic policies leading to a 40 % decline in consumer demand. Faced by this critical problem, new dealers eagerly searched for products that would secure their level of turnover and found that Western imports, no longer limited by import quotas, were more appropriate than products produced domestically. As a consequence, the decline in domestic industrial activity is partially blamed on the renewed purchasing policy of newly privatized retail trade units.

3.2 Former East Germany

Privatization of retail trade and consumer services in the bygone German Democratic Republic (GDR) was among the most rapid in former Eastern Europe. The process of small-scale privatization started shortly after the establishment of the monetary union with West Germany, midway through 1990. Like in other East European nations, privatization coincided with general economic reform.

In the one and a half years between 1 January 1990 and 30 June 1991, the Treuhand had privatized almost 85% of the retail trade and service outlets in its SSP program. By the end of 1991 most of the previously state-owned operations in trade and consumer services had been privatized.

Statistical data about the privatization of former *'HO'* (state) retail shops, restaurants and hotels give evidence of the dynamics of the privatization process. Out of the some 30,000 units 9,300 entries were privatized by October 1990 and another 14,000 by the end of June 1991. In this second period, two rounds of competitive bidding were organized: the first resulting in the sale of some 11,400, and the second in about 2,600 outlets. The privatization of 60% of the outlets was organized by branch offices of the Treuhand while the rest was arranged by the head office in Berlin.

The East German case showed that the centrally planned wholesale sector of the old communist days had no future in a privatized retail trade and service economy. In fact, in its previous form, this sector became totally useless and was completely unprepared to function as a modern distribution system. The Germans had two answers; firstly, privatize retail and wholesale essentially simultaneously; and secondly, allow Western wholesalers (primarily West German in this case) to enter the market.

Complete opening of the economy to the West, the breakdown of traditional markets, the inadequate establishment of a mature entrepreneurial environment, and the deficiency of managerial experience to exploit the potential of the re-privatized sector lead to not always beneficial changes in economic structure. These factors combined with a lack of skills in marketing, purchasing, controlling, finance, and technology and capital transfers have led to a sort of colonization of the most interesting and economically profitable activity in the East by the West.

Retail trade was considered as an important field by western investors. Therefore, the West German retail trade chains were eager to successfully bid for shops in East Germany. The chain **Spar** bought 2,000 outlets, **Edeka** 100, **Rewe** 200, and **Engle** 413, while other western retailers preferred green field investments (i.e., those required to build a completely new establishment from scratch)[10]. As a result of this avalanche of Western investment, the concentration of retail trade in East Germany still remained very high, certainly higher than in the western part of the country.

The Treuhand followed a policy of encouraging managers of shops under 100 m^2 to buy out their businesses. As a result, 36% per cent of all management buy-outs took place in the trade and service sector. Experts predict, however, that a lack of proficiency and financial power on the part of the new owners may force these shops to soon close in light of the competition provoked by the powerful, giant chains. These financially solid and aggressive firms show an active investment policy in the *'Neue Länder'*, and use every tool (like the way the infrastructure is reconstructed) to reshape consumer purchasing habits. A characteristic example is the construction of big supermarkets and department stores along the highway surrounding Berlin.

In addition to management buy-outs, another way of takeover of small and medium size business by East German businessmen was the re-privatization of those 4,000 firms that had been nationalized by the East German state in 1972. Unfortunately, the process of re-privatization did not gain much momentum in the last one and a half years. Only 25% to 30% of these enterprises could be taken

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10 See Müller (1991).

back by their original owners due to the often extensive alterations in the business premises and the profile of the activity.

The third manner in which private initiative could gain ground in the small scale sector of East Germany was with the growth of new small business in retail trade and catering. The initiative to establish new business was especially pervasive in 1991; however, by the middle of 1992, a certain balance was achieved between business openings and closures, the former still being twice as high as the latter. Statistical numbers also indicate that, as a rule, half of all openings and closures takes place in the retail trade and catering sector with the monthly openings averaging around 8,000 business units.

3.3 Hungary

Due to the high initial level of private ownership in retail trade and consumer services, the Hungarian SSP was not envisaged as a program for a large number of units, but rather for only 10,000. SSP was conceived as a catalyst for the progress of ensuing large scale privatization. For both the experts and the public did not take much time to learn that the dimensions of the program were much smaller than had been originally declared and the implementation was extremely slow.

It turned out that of the 10,000-10,300 outlets that were originally selected for pre-privatization, a great number was in cooperative or private ownership and accordingly not subject to the SSP law. Another 4,700 operated in leasing or other contractual arrangements where the contract did not make it possible to privatize the outlet before the expiration of the contract.[11] By April 1992, the property rights of only 680 outlets had been sold, while the rights to rent had been sold in the case of another 1,980. There were 560 additional shops where the form of privatization other than auction was applied (for instance, by converting or merging into a company).

Forty-three per cent of the biddings were unsuccessful and had to be repeated. The average sale price was about 140% of the starting price. The revenues from SSP, which have reached approximately 8 billion Forints (10 billion by August 1992), were to be used mostly to finance past and current national budget deficits as well as the costs of privatization.

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[11] According to a new law, introduced on 29 August, 1992, renters of these 4,700 outlets will have a 45 days period to apply for the purchase of the shop they currently rent. They will have the opportunity to buy it without auction at the book value of the premises or at the starting price of a fictitious auction.

The Hungarian SSP process was also contaminated by some circles that attempted to manipulate auctions, particularly if the starting price was perceived to be too high. This caused variations in selling prices. However, the implementation of the simplified auction under the SSP law facilitated an official reduction of the starting price. Consternation that others could subsequently afford the particular outlet, forced the potential manipulators to bid more seriously in the first round of auctioning in response to this disciplining mechanism.

While the eventual number of shops offered for SSP turned out to be low, the number of unsuccessful auctions was relatively high. This lack of interest on the side of Hungarian would-be entrepreneurs could be explained by two factors. The first is that too few outlets were offered for outright sale of premises and too many for selling the right for rent only. Hungarian citizens were reluctant to bid for outlets where they could buy the right for rent only, because no regulation guaranteed them the possibility to achieve an acceptable rent for the medium term in their negotiation with the owners, mostly the local authorities. These authorities usually forced the new renters to make a new contract containing higher, many times two or three times higher, rent than the state owned shop had paid in the previous period.

The other factor was the lack of preferential credits to be used in the SSP. In the summer of 1990, the government promised to provide a so-called *Existence Credit* for this purpose, but the Ministry of Finance and the banking system took almost one and a half years to precisely elaborate the conditions of this credit.

Due to the obstacles mentioned above, the new Hungarian entrepreneurial class habitually found it more rational and less expensive to start a business from scratch rather than buy an existing one via the SSP program. By the end of 1991, about 150,000 private retail traders were registered (half of them emerged in 1991) as opposed to the 3,000 outlets sold in the framework of the SSP. Unfortunately, this turn away from existing premises has begun to reduce the average level of quality, selection, and service of these often just single-person enterprises because their location and facilities are often inferior to those of the existing shops.

In addition, SSP played a limited role in transforming the Hungarian retail trade sector. In contrast to the privatization of the *existing* retail trade, the selling of large trade networks in one piece (not under the force of SSP), played a larger role than the SSP itself. The 3,000 outlets, which were privatized in SSP, constituted less than 12% of the existing state outlets in 1988.

One of the major controversies concerning the privatization of Hungarian retail trade was whether large retail trade chains should be privatized in one piece - in the framework of invited or advertised bidding, through negotiations with the SPA - or by units within the framework of the pre-privatization program. As mentioned above, many networks made themselves already inaccessible for SSP by steps undertaken in the phase of the spontaneous privatization (for instance by their transformation to joint ventures with foreign participation). Additionally, the SPA's insistence on achieving the highest revenue from privatization rendered many networks of specialized retail trade outlets, department stores, and hotels offered for sale in one piece and consequently mostly sold to foreign investors. As a whole, each individual piece usually proved to be too expensive for domestic buyers.

Newly privatized retail trade businesses in Hungary had to face a market full of new difficulties on the one hand, and a market showing certain signs of improvement on the other.

In the last two years, restrictive macroeconomic policies of the government caused consumer demand to decline by an annual 15%. Retail trade had to cope with the massive shrinkage of the market.

Simultaneously, however, the access of the trade sector to products they can sell improved dramatically. The cause of this was partly the progress of the liberalization of imports and partly sales problems of Hungarian producers in Eastern Europe. Upon loosing their potential markets in Eastern Europe, these producers were forced to court domestic retail traders in order to persuade them to select their products for sale. This turn of events helped retailers to attain a more balanced position *vis-á-vis* the wholesale enterprises[12].

The short term experiences with retail chains taken over by foreign investors are not unambiguously favorable. Some of the new owners did not make any modification to the supply or service of the old shops, but changed the name of the network and adjusted the prices upwards. Others introduced a selection of high-end products which masses of Hungarian consumers, suffering from the effects of current recession, could not afford to buy. A number of the new owners of these networks showed a surprising insensitivity for the actual demand of Hungarian consumers. They seemed to be less interested in making money in their new business and more satisfied with having gained control over valuable premises in the best places of the Hungarian capital.

As for the quantitative description of the behavior of newly privatized small scale retail trade business, we may summarize here some findings of a recent survey conducted by the KOPINT-DATORG Institute for Economic and Market Research and Informatics, Budapest[13].

The owners/renters of newly privatized units exhibited rather dynamic activity. More than 57% of the respondents made investments in their shop and

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[12] Privatization of wholesale companies has started; they will be privatized outside the framework of SSP.

[13] The source of this information as of many other aspects of SSP in Hungary summarized above is Palócz (1992).

more than 50% planned to undertake significant changes (investments) in the near future. Almost one third of the new owners/renters changed the profile of the shop: 57% of them has broadened the profile while only a very few narrowed it.

About two-thirds of the entrepreneurs bought an outlet using credit. The 300 respondents to the survey on the progress of SSP raised loans from 14 different banks.

The majority of the new owners/renters use standard suppliers, mostly the traditional, state owned wholesale trade companies. This seems to be a special feature of the pre-privatized small shops since, in the other sectors of retail trade, experiences show that a growing number of the firms try to bypass wholesale traders and use direct purchase from producers or from import.

About half of the respondents revealed that the newly privatized shop was not his/her first venture, and 40% of them still operate one or more additional businesses. This feature indicates that those having participated in the SSP were not without previous experience, a massive part of them joined the entrepreneurial sector during the eighties. In fact, to buy a shop in Hungary for some million Hungarian forints (even with credit) is a risky venture and it would have been even more risky for people with absolutely no previous experience.

3.4 Poland

After the elections of the new municipal authorities, these new administrative bodies embarked on a vigorous privatization of the outlets under their control.

The Polish population has been identified as always having sufficient funds at their disposal to start small business. Also, tax holidays were granted for small business during this time. As a result, municipalities saw a chance to gain much revenue by a fast privatization of retail trade outlets in face of the strong demand.

Due to a deficiency of detailed regulations other than some general guidelines from the central government, each of the municipal authorities were permitted to independently devise rules of behavior for this purpose. The outcome was a variety of methods for allocating rental contracts for the premises.

The outright sale of the retail premises were perceived as less favorable under the existing conditions. The legal status of the outlets were too unintelligible for accomplishing a full transfer of property rights. Yet, even if this could have been solved, the municipalities themselves preferred a continuing flow of budgetary revenues rather than a lump-sum payment for a sale, and also preferred the maintenance of their power as the owners and administrators preserved under rental agreements. Even a modification in the civil code in

October 1990 to enhance the outright sale of various kinds of premises did not lead to a substantial rise in outright sales: only 3% of the units privatized were actually sold by the end of 1991, while the remainder was rented.

The methods of allocating the rental contracts varied from the more administrative, but unclear approach to the less discriminatory, most transparent market technique. Some authorities opted for an organization where contracts were drawn up with previous employees or agents having had a relation to the earlier business operation of the outlet (i.e., with insiders) excluding all other parties, and agreed on a notional, low rental fee. Others organized tenders but for a restricted group of possible buyers only. Another group of authorities preferred the open advertisement of auctions for everybody, and either gave preferential treatment for insiders, or granted equal treatment to anyone expressing interest. The variety of the methods used by municipalities is well reflected in the fact that the employees of retail outlets were treated differently in different districts within Warsaw.

Despite the great variety of methods, privatization was biased toward administrative allocation of renting rights versus allocation through the market. While in Czechoslovakia and Hungary the application of open auctions was a rule, in Poland they were exceptions. Out of the 43,000 rental agreements concluded within the framework of SSP, only 4% were completed through unrestricted, open auctions by June 1991.

Municipalities showed a clear preference for insiders in the allocation of rental agreements. This bias has been achieved partly by various forms of pressure of the groups of insiders: they demanded favorable treatment, low rental fees, were extremely well organized, and supported by trade unions. The administrative allocation, favoring insiders also resulted in rental fees that were usually much lower than the fees achieved through open auctions (the latter were 10 to 100 times higher than the former). This fact explains why closed allocation of rental deals were so vulnerable to corruption and other negative aspects.

Municipalities were not regulated by prescriptions of the center. However, as a consequence of their similar thinking and vested interests, they tended to issue similar resolutions concerning SSP. For instance, many municipalities imposed two conditions on the insiders with whom they intended to make a contract. First, the insiders had to form a partnership or limited liability company comprising all the existing employees or at least 50% of them and, second, insiders applying for the rental agreement had to be employees in the given outlet for a predetermined period of time (this latter condition served to exclude influential outsiders, like old *nomenclatura*, from the preferences granted to insiders).

While the new municipalities were totally unprepared for the tasks required for the organization of the SSP, and undoubtedly made errors and even transgressions, the pace of small scale privatization in Poland reached a remarkable rate. Different sources show different results: Grosfeld-Hare (1991) as well as Dabrowski (1991) estimate that 40% to 50% of all shops were privatized by the end of 1990, while the Polish Ministry of Privatization (1991) put this ratio to 80%. According to government estimates in September 1991 private retail trade turnover amounted to 72% of the turnover of the whole retail trade sector[14].

Statistical data, however, indicates another interesting feature of the privatization process in Poland. In the year 1990, the number of retail trade outlets in Poland increased from 72,000 to 346,000. This explosion of private activity clearly cannot be explained only by the privatization of the 30,000 to 50,000 outlets previously owned by the state. One should be reminded of a similar characteristic feature as in the case of Hungary: the establishment of new businesses from scratch was more frequent than the conversion of previous state owned outlets and played an equally important, if not dominant role, in the privatization of economic activity.

Public acceptance of SSP was mixed, but generally positive. Clearly the ownership change in tens of thousands of retail outlets contributed substantially to the secular shift in the supply of goods and services in Poland, quickly changing the appearance of towns and the perceived quality of everyday life. However the implementation of the SSP also raised doubts and caused frustration in the population. The imprecise rules of the realization of the process, the absence of clear, unified methods of valuation, the inadequate distribution of the information concerning the governing rules of privatization and preferences for insiders all generated tensions and conflicts. Public discontent emerged both when artificially low rents were agreed upon with selected partners in closed negotiations and when exorbitant rents were secured in some open auctions for premises in high demand.

Among the ambiguities of the legal framework one must also mention the problem of restitution which unlike in Germany, Czechoslovakia and Hungary has not been seriously tackled in Poland.

When the privatization program for retail trade began, major questions arose concerning the state of wholesale trade, as it was still highly monopolized in 1990. The retailers had their difficulties with the big state enterprises dominating distribution and wholesale. The transformation of the ownership pattern in this field remains ambiguous. State wholesale companies lost one-fifth of their warehouse space in 1990, most probably through privatization. Private entrepreneurs also showed vigor in setting up new wholesale businesses: by the end of 1990, about 35,000 private businesses were registered as wholesalers or mixed retailers and wholesalers. The government also tried to challenge the dominance of state wholesale companies by the liberalization of imports and by making it free to set up importing businesses. The wholesale sector, however, has essentially stayed in the hands of state companies. The main cause was the plan to privatize distribution and wholesale enterprises as part of the large-scale privatization scheme which made less progress in the first years of the

[14] Quoted by Tamowicz, et al (1992). In compiling this summary of Polish SSP we have relied heavily on this remarkable study.

privatization phase.

3.5 *Russia*

The progress of the small-scale privatization process has been extremely unevenly distributed in Russia, some regions far along the path and others not even ready to begin the process[15]. During the early stages, SSP has been primarily concentrated in all large Russian cities. Moscow has taken the lead; however, some experts allege that this is largely ascribed to the extremely flexible application of SSP guidelines and independent modifications when so desired. Small outlets are not being auctioned, but rather given away to the collective of their workers or employees (actually, sold at a non-market determined price of 1,000 rubles per square meter of total space), preserving monopoly-style operation and leaving the property largely in the hands of the former *nomenclatura*. Of the 6,000 shops privatized in Moscow, 70% were disposed in this manner.

The Moscow *'give-away style'* of privatization has been said to encourage the criminal factor. Much capital is supposedly flowing in from the grey economy and is subsequently often behind employee acquisitions. As a result, the SSP has lost some credibility and the receipts from privatization have not been as high as they could under more virtuous circumstances.

Such a custom, aside from its clear advantages (such as facilitating a high speed of privatization), leads to preservation of the previously and currently highly monopolized and corrupted system of retail trade in Moscow. Personnel remaining from the previous system, with its old connections to the upstream monopolies, good level of social security, and historically high incomes (in kind and in cash terms), are confronted with insufficient incentives to develop their businesses. At the same time, the process of creating new small enterprises is much less successful in Moscow due to the significant level of corruption among local authorities.

The way privatization has been accomplished in Nizhny reveals a more prospective alternative to the Moscow-type privatization. Until today, the weekly auctions in Nizhny have proven to be the most frequented (by sellers and buyers) and the most representative in Russia. As of June 15, 12 auctions had been held at which 120 outlets had been sold. Although these numbers still appear modest, they are increasing rapidly and, more importantly, expanding geographically.

The special features of the auctions in Nizhny are that the items sold in 90% of the cases have not been the objects themselves, but rather the rights to lease for five years with additional rights to buy the outlets at an estimated value after the lease is terminated (as of June 12, only 10 units have been sold outright).

[15] For example, in the Novosibirsk Oblast revenues from SSP have reached an amazing 300 million Rubles, while in the Omsk Oblast not a single Ruble of privatization has come in yet.

This arrangement was the result of technical reasons: land is not yet the subject of ownership and almost all outlets are located in the ground-floors of bigger buildings, the owners of which are yet to be identified. However, in some other cities, local authorities have managed to solve this problem in some fashion, significantly increasing auction receipts: for instance, in Belgorod, two auctions with outright sale were held with an average price of 20 million rubles per grocery store - that is 5 to 7 times as much as in Nizhny.

As mentioned above, early in 1992, a hierarchical structure of privatization administration had been set up. In May, this new structure was operationalized and a combination of administrative and economic tools implemented via the hierarchical decision-making process. The response over just the next 30 days was a tripling of the rate of privatization. While earlier the number of privatized shops was at a mere 55, it rose to 800 by mid June. Of course, the 800 is still a very small proportion of the 150,000 retail shops, 70,000 canteens and cafes, and 30,000 outlets of consumer related services owned by the state throughout the country. Most have been well integrated into the large administrative organizations of the city and local administrations. They are a part of the bureaucratic apparatus and are monopolies with respect to activity and/or location.

However, these figures do not include 25% of retail and service outlets that have traditionally belonged to many enormous vertically integrated industrial enterprises. They were originally created for the provision of workers in the enterprises.

As far as prices of the privatized outlets are concerned, they were on average 50 to 100 times the original book value of the premises in Nizhny. The initial surge of interest reflected by the high prices offered by prospective buyers throughout Russia, was followed by what appeared to be a drop in demand for the privatized units if the evolution of selling prices is used as an indicator. In April, the average selling price was 30 times the calling price at the auction, in May it dropped to 25 times, and by June the difference had declined to 7 times or less. This phenomena was not unknown in some Central and East European economies, and was generally a function of capital availability, expectations, modifications in the regulations, and corruption.

Throughout Russia, receipts from SSP have grown by a factor of 30 over the last three months before June 1992. The buyers, primarily form Nizhny's recently emerging commercial sector, readily have the required 3 to 5 million rubles available in order to purchase the right to five year leases of grocery stores, barber shops or canteens; most of them without binding conditions on the future business profile. (According to guidelines set by the Committee for the Management of State Property, not more than 40% of the units can be sold on a binding condition in urban areas.)

Employed personnel of outlets posted for auction have played an important role in the bidding process. For example, 10 out of the 22 units auctioned on 4 April in Nizhny were bought by their employees. As mentioned in the previous section (2.5), interest of *'internal'* investors were enhanced by significant advantages.

The first effects of commercialization and privatization of small scale business have become evident: queues have almost disappeared. Nonetheless, people are still running all around trying to identify *'the true market price'*. Equalization of prices is said to just be a question of time. However, the problem of supply response has not yet been solved. Most of the upstream industries enjoy a monopoly position and still rely on government subsidies and cheap credits.

More important are the social implications of the privatization program. Workers of retail trade and services - once a mighty and spoiled group - became as unprotected as everyone else. Local authorities lost their access to cheap subsidized goods: old *'apparatchiks'* just like previously privileged retail trade workers are also not pleased with the reform[16]. Regional population, in general, does not oppose the SSP. However, few impulsive protests were reported. In Nizhny, every auction is accompanied by a few pickets of trade workers, retired staff, and the so-called *patriots*. In general, reform goes well, although, unfortunately, two privatization related murders were reported in Moscow. But this is still incomparable to the violence which accompanied the reverse process in 1917.

New owners of retail outlets try to shape their own business policy to fight consequences of decline in consumer demand due to the current tightening of the monetary policy. As a consequence many of the privatized stores do not sell staples, but rather opt for luxury products that are also out of the average person's price range.

Consumers often associate privatization with price hikes that are generally beyond their financial means, particularly if they are pensioners or the poor. So, due to changes in business profiles and price increases (though they are really the function of abolished subsidies), privatization is often related to the introduction of difficulties into life, and not solely advantages. This influences the psychology towards privatization, and its acceptance by the consumers.

There are a few general problems facing Russian central and local authorities in the process of the small scale privatization. The following is a list and explanation of the presently most important issues.

1. **Ownership of premises:**
In a number industrial cities, retail outlets' premises are not just public but

[16] There is even open opposition of local authorities to reform in places like Voronezh and Koursk.

rather belong (up to 90% in some areas) to large industrial enterprises[17] which, already in the process of commercialization, impede the privatization of outlets. The enterprises are unwilling to give up the outlets, because they would not be able to control supply of consumer goods for their personnel and, no less important, they would lose effective potential sources of revenues.

Another problem with respect to ownership is characteristic of outlets having been sold to groups of employees. As experiences of the majority of shops privatized in Moscow show, the behavior of these units has not changed much because a collective of old employees does not have the impression of truly being owners. Their shop is at the end of the still monopolized chain of state goods distribution and no individual employee is permitted to do with his individual share in the shop what he/she likes[18]. The true feeling of ownership is only felt once one can do with his or her property as he or she so desires. Thus, there has been little or no change in quality and selection of goods and services in these shops. In contrast, the sale of retail trade or services outlets to new owners result in a completely different picture featuring wider selection, polite service, more modern sales style, and the feeling that people like to work and work well.

2. **Leftovers of central planning:**
Retail trade outlets now being commercialized and privatized, are still lacking working capital, distribution and transportation infrastructure, logistics, raw materials and other goods supply, and storing facilities. These all belong to their former *'parents'*, the great regional monopolies of retailing -- so-called TORGi.

In 1990, as much as 30% of these TORGi signed agreements with the former Soviet Ministry of Trade (which has successors now) about leasing of their property with additional rights to buy it when leases expire. Only the court is able to dissolve those agreements, and only in case of serious infringements. If TORGi do not violate their agreements, small shops keep lacking working capital, transportation means and storing facilities. This problem impedes the separation and privatization of potential objects for SSP. Many facilities that have broken away from the TORGi empires have

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[17] Even in Nizhny, the pioneer in small scale privatization, there is a conflict between local authorities and GAZ - the giant VOLGA car factory - with respect to this issue. The automobile producer with all its auxiliary operations possesses more economic clout than all the city's other enterprises together, including those under municipal authority.

[18] Following the traditional and conventional communist/socialist principle, each employee received an equal share in an operation, regardless of fairness or effort. Not only has this provided plenty of incentive to just stroll along as a free rider, but the employees must now be unanimous in a bid to sell their outlet. No individual can sell his or her share. In only 52 cases so far did employees actually agree to sell to one single entrepreneur. A very small percentage of the total number of shops privatized by transfer to employees.

preserved their monopoly status regionally and inter-regionally. Thus, the problem is not simply solved by breaking up the great monopolies.

3. **Loss-making trade and services in remote rural areas:**
Much of the trade and, especially, services in remote rural regions were historically substantially subsidized for an extended period of time. Now, under commercialization, they have difficulty to just survive. Although economically it is inefficient, socially it is necessary to maintain them for a long time. Without infrastructures, rural areas will further deteriorate.

4. **High monopolization of wholesale trade:**
For more than seven decades Russia has had a unified, centralized system of storing facilities upon which the retail shops were totally dependent. The lack of an adequate infrastructure on the supply side of the privatized retail trade and service outlets causes problems for the entire process. The viability of the single units is questionable and their operation risky.

   In a number of regions, successful privatization of small retail outlets without accompanying privatization of wholesale networks leads to a paralysis of retail trade and consumer related services. The newly privatized shops are required to find storage facilities, transportation means, suppliers and more by themselves; something quite new for someone growing up under central distribution systems. Again, back in 1990, already 100% of wholesale networks signed agreements with the former Soviet Ministry of Trade about leasing of their property with additional rights to buy after leasing agreement expires: agreements which only the courts can dissolve.

5. **Vague property rights and bureaucratic procedures**:
Russian SSP, and especially the potential participation of outsiders, is additionally still troubled by immature property rights legislation and the complete lack of a state program supporting small entrepreneurship. For most business activities no license is required, but the new entrepreneur must get approval for his or her business profile from his or her future competitors -- the still state-owned monopolies. Also, the required documents for opening a small business are substantial in number and the process considerably onerous, though not necessarily complex.

6. **Current decline in demand for outlets posted in auctions:**
The most recent tendency, along with a rapidly growing number of units sold, is a sharp decline in clearing prices and the contraction of demand in general[19]. This fact is attributed to the current tightening of the monetary policy by the Central Bank of Russia.

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[19] In Nizhny, for example, on 4 April 22 outlets have been sold for between 3 and 5 million rubles each, and 80 bidders participated. At another auction in late May, 10 outlets were auctioned to only 20 bidders, and prices were around 1 million rubles apiece.

The occasionally experienced declining demand in the auctions for outlets will experience a durable upswing with the introduction of personal privatization accounts and vouchers expected towards the end of this year. These vouchers will be introduced by 1 November 1992 in the RFR. The other problems can hardly be solved within the next few months and even years. There are some elegant solutions; for instance, transformation of TORGi into joint stock companies which belong to their former subsidiaries - the retail trade outlets[20]. But these solutions require consensus of all parties involved, and, not least, plenty of time.

4. Conclusions

Small-scale privatization in the last four years has contributed to and stimulated the emergence of the private sector in Central East Europe and Russia. The importance of this sector in the whole economy has expanded dramatically. The share of private sector sales revenue have increased substantially and most of the countries have gone from having virtually no private sector ten or less years ago, to having a full-fledged private sector in retail, services, and some manufacturing by June 1992.

In most countries of the region the privatization of state property acted as a catalyst in the stimulation of new business, while in some of the countries like Hungary and Poland earlier deregulation and longer traditions rendered the privatization of existing state owned outlets less important and the establishment of new business more significant. Small scale privatization has also been responsible for altering the populations perspective and psychological impasse to the merits private initiative.

In addition, the quality of goods and service, the general level of selection including imported products, as well as the presentation and style of sale have all greatly improved. Partly due to effective macroeconomic policies and partly to a more responsive retail trade sector queues have disappeared and there is more to buy than people can afford. Everything from opening hours to advertising have seen significant changes. The number of shops has increased dramatically, convenience has improved in many ways, and competition has been ignited among domestic retailers and service people. There is hope that this may reverberate all the way through the up-stream supply channels. The populations are becoming educated about the functions (the advantages and disadvantages) of a market economy.

Some progress has been achieved in establishing and developing an entrepreneurial class, as well as in the creation of infrastructure necessary to

[20] There are already precedents of such a kind in Novosibirsk, Omsk, and Volgograd.

support SSP and the subsequent operation of these new enterprises. Business has become much freer relative to the past, though it is not always easy to become an entrepreneur and operate a retail or service outlet in the private sector. Nevertheless, the establishment of the background of this institutional support is lagging well behind the growth of privatized business. This feature is partly responsible for the hardships newly privatized business must endure early in their activity and for failures of just started businesses.

The progress of the financial sector, including the infrastructure of banks and credit institutions, is of crucial importance for a further development of the small scale sector. Without massive credit lines under favorable credit conditions, the majority of the new entrepreneurs may have to close their new venture before their ability for conducting business could have been proven one way or the other. Another useful form of support, unfortunately not very often utilized, is a system of tax breaks and investment incentives for new entrepreneurs.

Some SSP programs or their implementation have shown clear preference for former employees and/or managers of the outlets targeted for privatization (Poland, former East Germany and Russia), while others (like those of the CSFR and Hungary) gave equal opportunities for outsiders. The clear, strong and across the board preference for the collective of previous employees appears to be disadvantageous. If the workers receive the outlet virtually free, there will be too little incentive to restructure the business and to rationalize on personnel under economic conditions in the transition to a market economy. However, if buying the outlet is a substantial investment for them, then the arrangement carries a high risk, since they put all their savings and earnings into one enterprise; that is, if they have such savings. In other cases, the lack of capital impedes acquisition of potential enterprises.

A characteristic and common feature of SSP in each country is the preference for domestic investors, or even the exclusion of foreign ones. It is justified that, should these countries embark on a prolonged process of privatizing of a dominant share of state owned business, prospective indigenous entrepreneurs, lacking the necessary capital to compete with foreign bidders, should be secured sufficient incentives to maintain a fair opportunity for access to small scale business. Each country made provisions against foreign involvement. One should keep it in his/her mind, however that no provision can be complete. The Czechs are seriously concerned that while foreigners were excluded from the first wave of auctions for retail trade outlets, it had little effect as a major part of this sector is owned by Germans already. In Hungary, the exclusion of foreigners from bidding for 3,000 privatized outlets means nothing if compared to the more than 100,000 other outlets they can buy either one by one or in the form of networks.

As for the speed of SSP, we have seen very swift programs (CSFR and Poland) and a slow one (Hungary). The also rapid German case should be only considered in context of its peculiarity (the involvement of West German capital) and the speed of Russian SSP cannot yet be measured. Speedy privatization has its obvious advantages: a rapid transition from coordination by central planning to trade without any inefficient transitory method of coordination and the avoidance of detrimental effects of spontaneous privatization, or absorbing the assets of the business. One should be aware of the fact, however, that the faster the SSP is, the more complaints can be expected about loss of privatization revenues, unclear bidding procedures, and corruption.

An SSP organized in a short period of time does not mean a completion of the process. Guidelines and procedures for a second round of SSP may have to soon be formulated, in order to encourage and regulate the outright sale of premises after the renting contracts expire and property rights of premises are clarified.

In order to ensure truly brisk SSP, some countries deliberately avoided the application of very detailed, intricate regulations. Policy-makers in the CSFR, for instance, were much in favor of having only a skeleton of laws and well specified institutions to carry out the SSP. Polish regulation was also very loose and simple, and also reflected a full trust in the initiatives of local authorities.

The favorable effects of a quick privatization process can easily be eliminated by a tardy privatization of monopolized wholesale trade and/or upstream suppliers. Czechoslovakia, Hungary and Poland each tried to compensate for the delay in this corresponding privatization by effectively deregulating entry to these markets and liberalizing their imports. It remains to be seen how the Russian private sector can survive without comparable support of trade deregulation and inflow of imports.

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Appendix

DESCRIPTION OF SESSION TOPICS

FOR THE WORKSHOP

Small Scale Privatization: Experiences from Eastern Europe

IIASA, Laxenburg, Austria, 26--28 June 1992

SESSION 1: **The Elaboration of the Program of Small Scale Privatization**

- The state of the retail-trade and consumer related services sector before privatization begins (subordination to central or local planning/control, level of monopolization, occurrence of competition, property-leasing relations in the different subsectors of the sector, adaptation to changes in demand, level of technical development, efficiency);

- The elaboration of the privatization program (political forces pressing for fast elaboration; the involvement of central and local government administration, different interest groups, enterprise management and employees in the elaboration of the program, level of legislation used to set up the rules for small scale privatization);

- The planned schedule of privatization and the main organizations involved.

SESSION 2: **Principles and Techniques of Small Scale Privatization**

- Restitution and small scale privatization;
- The effect of earlier property/leasing relations, as well as employee status in the ensuing privatization;
- The option of privatizing individual units or chains;
- The option of parallel privatization of the wholesale companies having been connected to retail trade;
- The status of foreign capital in small scale privatization;
- Binding conditions in the line of business for the future operation of the units;
- The use of revenue from privatization;

- Major form of privatization: outright sale, leasing, sale of the use of premises for a fixed period of time;
- The assessment of the initial value of the units;
- The organization of competitive bidding;
- The methods of financing the purchase of small shops (preferential credits, installments, notes of restitution, etc.);
- Other preferences or advantages provided for the new owners of small scale business units;
- The distribution of power (responsibilities) between central government and local authorities in the implementation of privatization.

SESSION 3: **Implementation of the Plan for Small Scale Privatization: Problems and Dilemmas**

- Unlawful practices: corruption, paying for withdrawal, fake bidding, disguised involvement of foreign capital, mafia takeover. Their occurrence, prevention attempts;
- Unsuccessful auctions, forced devaluation of assets;
- Unwillingness of local authorities to supply the expected number of units for privatization;
- Unwillingness on the part of financial organizations to provide the needed preferential credits for small scale privatization;
- Opposition of the public to the sale of business units without binding in the line of the future operation of the business;
- Conflicts between central government and local authorities.

SESSION 4: **The Present State of the Small Scale Sector and the Behavior of Privatized Units**

- The progress until now in the small scale privatization program, future time schedule;
- Changes in the line of business after privatization;
- Changes in the suppliers of retail trade units (preference for imports or other new suppliers);
- Changes in the methods and quality of service after privatization;
- Investment activity after privatization;
- The frequency and major causes of bankruptcies of newly privatized business units;
- Present state of the market (ownership relations, level of monopolization, occurrence of competition, growing and declining lines of business).

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for the workshop on

Small-Scale Privatization: Experiences from Eastern Europe

IIASA, Laxenburg, Austria, 26--28 June 1992

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