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Did Competition Help to Achieve Positive Effects of Privatization?

¿La competencia ayudó a lograr efectos positivos de la privatización?

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Contents

ABSTRACT:
The article is devoted to finding the answer to the question whether competition helped to achieve positive effects of privatization. The objects of the research are economies in Central and Eastern Europe (CEE) and in the Commonwealth of Independent States (CIS) that have experienced significant changes in views and values due to changes in the economic system. The positive effects of competition are discussed with some application to privatization. Secondly, the authors use the findings of the researchers who tested the effects of competitive pressure in some of the transition economies. Thirdly, it is shown that the effects of competition may diverge in the short run and the long run. Then, there is evaluation of other factors, different from competition but crucial for the sustainable transition process. The article also contains the case that shows that it was possible to see positive effects of privatization even without competition. As a result of the research, the authors have come to the conclusion that competition was not just bringing some positive effects of privatization; it was the main source of positive outcomes for the transition economies that could be seen after a certain period of time.
Key words: competition, privatization, Central and Eastern Europe, Commonwealth of Independent States,

RESUMEN:
El artículo está dedicado a encontrar la respuesta a la pregunta de si la competencia ayudó a lograr los efectos positivos de la privatización. Los objetivos de la investigación son las economías de Europa Central y Oriental (CEE) y de la Comunidad de Estados Independientes (CEI) que han experimentado cambios significativos en sus puntos de vista y valores debido a los cambios en el sistema económico. Los efectos positivos de la competencia se discuten con alguna aplicación a la privatización. En segundo lugar, los autores utilizan los hallazgos de los investigadores que probaron los efectos de la presión competitiva en algunas de las economías en transición. En tercer lugar, se muestra que los efectos de la competencia pueden divergir en el corto y largo plazo. Luego, se evalúan otros factores, diferentes de la competencia, pero cruciales para el proceso de transición sostenible. El artículo también contiene el caso que muestra que era posible ver los efectos positivos de la privatización incluso sin competencia. Como resultado de la investigación, los autores llegaron a la conclusión de que la competencia no solo generaba algunos efectos positivos de la privatización; era la principal fuente de resultados positivos para las economías en transición que podía verse después de un cierto período de

transition economy.

tiempo.
Palabras clave: competencia, privatización, Europa central y oriental, Comunidad de Estados Independientes, economía de transición.

1. Introduction

The economies in Central and Eastern Europe (CEE) and in Commonwealth of Independent States (CIS) have experienced significant changes in views and values due to changes in the economic system. These transition economies have gone through the process of privatization of major state-owned companies in order to improve the functioning of their legal and institutional framework [6]. Such changes lead to a major increase in the share of private sector GDP. It soared from extremely low levels to between 60% and 90% [7]. The purpose of this work is to determine whether competition helped to achieve positive effects of privatization.

In order to achieve the set goal and solve the specified scientific problem, the work will be structured in a certain way. Firstly, the positive effects of competition will be discussed with some application to privatization. Secondly, we will use the findings of the researchers who tested the effects of competitive pressure in some of the transition economies. Thirdly, we will show that the effects of competition may diverge in the short run and the long run. Then, there is evaluation of other factors, different from competition but crucial for the sustainable transition process. The last part of the analysis contains the case that shows that it was possible to see positive effects of privatization even without competition.

2. Materials and method

The paper by Konings et al. looked on the effects of competitive pressure in Transition economies. In this paper the authors analyzed the impact of competitive pressure on companies' performance. The paper used econometric analysis to represent its findings for Bulgaria, Romania and Poland. The data was based on the reported corporate accounts of firms in manufacturing sector. The data for the three countries covered more than 60% of total sales in manufacturing and could be seen as representative. The author used two indicators of competitive pressure: the Herfinandhl concentration ratio, which is the sum of the squares of the market shares for each firm within the industry [3] and import penetration.

The results of including competitive pressure, without data on majority ownership can be seen in the tables 1-3. Looking at the results of the fixed effects estimation, it is possible to see that in Bulgaria increased concentration ratio did not have a significant effect on total factor productivity (TFP). However, for Romania and Poland increased competition caused a decrease in TFP. Also, when the model was tested against import penetration, it showed that its effect is negative and statistically significant in Romania and Bulgaria and positive in Poland. Therefore, it is possible to assume that in these countries, the increase in competition did not prove the benefits of privatization such as increase in efficiency and productivity of organizations [13].

Table 1
Effect of ownership, concentration and import penetration on performance in Bulgaria

	(1)			(2)		
Dep.var.: valt	**OLS**	**RE**	**FE**	**OLS**	**RE**	**FE**
nit	0.87*** (0.05)	0.82***(0.04)	0.67*** (0.12)	0.85*** (0.05)	0.81***(0.04)	0.66*** (0.12)
kit	0.25*** (0.02)	0.25*** (0.02)	0.19*** (0.04)	0.23*** (0.02)	0.24***(0.02)	0.19*** (0.04)

privit	0.37*** (0.07)	0.36***(0.07)	0.15 (0.12)	0.37*** (0.07)	0.35*** (0.07)	0.15 (0.12)
foreignit	0.83''' (0.2)	0.71***(0.13)	0.29* (0.19)	0.83*** (0.20)	0.71***(0.13)	0.32* (0.19)
herfjt				0.83*** (0.26)	0.79***(0.20)	0.48 (0.32)
impjt				-0.41*** (0.11)	-0.47***(0.11)	-0.46* (0.28)
Year dummy	yes	yes	yes	yes	yes	yes
Hausman test		Prob>chi2=0.03			Prob>chi2=0.11	
R2	0.56	0.56	0.55	0.56	0.56	0.56
# obs.		1995			1984	

*Note: robust standard error in parentheses, ***/**/* denote statistical significance at l%/5%/10%; overall R2 in the random and fixed effects specifications*
Source: Authors

Table 2
Effect of ownership, concentration and import penetration on performance in Romania

	(1)			(2)		
Dep.var.: valt	**OLS**	**RE**	**FE**	**OLS**	**RE**	**FE**
nit	0.78*** (0.03)	0.79 (0.02)	0.68*** (0.06)	0.77*** (0.03)	0.79***(0.02)	0.67*** (0.06)
kit	0.25*** (0.02)	0.21***(0.01)	0.11*** (0.03)	0.24*** (0.02)	0.21***(0.01)	0.11*** (0.03)
privit	0.85*** (0.05)	0.76*** (0.05)	0.31** (0.14)	0.86*** (0.05)	0.76***(0.05)	0.30** (0.14)
foreignit	1.37*** (0.07)	1.31***(0.07)	0.09 (0.35)	1.38*** (0.07)	1.31***(0.07)	0.09 (0.35)
herfjt				0.63*** (0.22)	0.35 (0.23)	-1.91*** (0.50)
impjt				-0.28***	-0.31*** (0.09)	-0.60**

				(0.10)		(0.29)
Year dummy	yes	yes	yes	yes	yes	Yes
Hausman test		Prob>chi2=0.00			Prob>chi2=0.00	
R2	0.63	0.63	0.57	0.63	0.63	0.53
# obs.		3002			2942	

Source: Authors

Table 3
Effects of ownership, concentration and import penetration on firm performance in Poland

	(1)			(2)		
Dep.var.: valt	**OLS**	**RE**	**FE**	**OLS**	**RE**	**FE**
nit	0.66*** (0.008)	0.69*** (0.007)	0.74*** (0.011)	0.66*** (0.008)	0.69***(0.008)	0.75*** (0.011)
kit	0.26*** (0.005)	0.23*** (.005)	0.16*** (0.008)	0.26*** (0.005)	0.23***(0.005)	0.16*** (0.008)
privit	0.26*** (0.022)	0.30***(0.027)	0.28*** (0.050)	0.24*** (0.023	0.32*** (0.027)	0.26*** (0.050)
foreignit	0.39 (0.027)	0.44*** (0.034)	0.30 (0.071)	0.37*** (0.028)	0.46*** (0.03)	0.29*** (0.071)
herfjt				0.30*** (0.101)	2.08***(0.26)	-1.39** (0.63)
impjt				-0.22*** (0.048)	-0.25"**** (0.06)	0.62*** (0.17)
Year dummy	yes	yes	yes	yes	yes	yes
Hausman test		Prob>chi2=0.000			Prob>chi2=0.000	
R2	0.70	0.70	0.69	0.70	0.70	0.69
# obs.			17570			

Source: Authors

However, the same researchers did another regression where they tested whether competition had different effects in privatized companies rather than in state firms. This test was more representative to show the effects of privatization, as state owned enterprises should be excluded to see those effects. Konings et al. focused on the results of fixed effects model. The results from Bulgaria, Romania and Poland showed that the direct effects of private ownership were positive and statistically significant [13]. Domestic competition resulted in increase in productivity; while import competition had a negative impact because the technology diverged between domestic and foreign markets. Import penetration brought a decrease in TFP for Bulgaria and Romania. Competition in domestic market leads to restructuring and improvement of performance, while the presence of foreign firms with competitive advantage damaged domestic industries. Romania and Bulgaria lagged behind the transition process. Therefore, import competition pressure for these countries was reducing their TFP, while internal competition created a "selection mechanism", where the most productive firms were winning over the market share [13].

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3. Results

The transformation of state enterprises into private sector gives some positive results such as improved corporate efficiency [20]. According to Estrin, most of the CEE and CIS countries experienced increase in such factors as growth, performance of the companies, total factor productivity and profitability after the privatization [6]. The fundamental difference between state and private sector owned enterprises is that private sector is profit orientated, which generates closer attention to efficiency of production and to the market as a whole. Even if the government has an objective of profit orientation, they cannot ignore other politics related objectives such as creation and maintenance of sufficient employment levels or holding prices below average costs for redistribution reasons. Therefore, for the government, profit is a secondary objective or even an irrelevant one, when business decisions become politicized [17].

Taking a closer look on microeconomic theory of competitive markets and reflecting it on transition economies to analyze the effects, market structure is the most important determinant in firms' behavior. During the socialist regime, the government owned most of the assets and was a monopolist. A monopoly is the only supplier of a good for which there is no substitute [14]. Government used to set its own price on goods and its' output was the only output. Although, in a classic monopoly theory, the monopolist sets the prices above marginal cost to maximise its profit, centrally owned assets were usually loss making and were heavily subsidized by the government. When the assets were privatized, firms became competitive and profit driven. The number of private companies increased exponentially as lower barriers to entry, allowed new companies to enter the market [14].

According to [14], the creation of market economy and competition opens up the possibilities of economy expansion by the means of entrepreneurial activity. One of the features of economic growth is higher employment, and tax revenues to fund social services. However, the end of public sector domination and decrease in subsides caused a massive increase in unemployment, with many people losing their income. Moreover, there was a decline of social and welfare services attached to enterprises, which enhanced the problems caused by unemployment in transition economies.

Ellman has written, that the main task of management in transition economies was restructuring. One of the examples of restructuring was financial restructuring. Many privatized organizations were left with wasteful recourses that were costly to keep: plants, lands and labor force. Many of these assets had to be stripped away [16]. Even before the output drop the reduction of labor force was around 25% in transition countries and after the drop, the unemployment problem worsened further [12]. Therefore, short-run effects of competition, during the transition period on employment, were seen as strongly negative.

It was clear that the countries without recent experience of high unemployment were suddenly put to the shock of job insecurity and massive redundancies, but it can be seen as an essential part of the transition period. It was the cure of problems rather than the cause. Indeed, it was difficult to overcome the legacy of command economy system with its sustainable long-run employment maintaining too much of inefficient labor, working in government-backed industries by destroying the labor market [16]. However, this period could also seen as "job-loss" growth where privatization was associated with restructuring of the labor force. Even in the industries, where expansion due to high investment flows was inevitable, it experienced a short-term decline in employment before long-term growth [16]. Therefore, it comes to the unexpected result - the increase in unemployment due to the competitive pressure in the short run gave the positive results of privatization such as increase in efficiency in the long run.

Competition is not the only factor that gave positive effects of privatization. Most of the factors are mentioned in Washington Consensus. The reforms targeted the achievement of economic prosperity for developing countries. The policies were mostly set by International Monetary Fund and World Bank [9]. The factor that is believed to be supporting the process of privatization, even in terms of competition, was enforcement of legal structure of transition economies, especially property rights.

"The legal system should provide secure property rights without excessive costs and make these available to the informal sector". Gray believes that countries in the period of transition from central planning to market economy, may come across a certain problem – laws may only exist but be unknown or not followed by public or state. This can result in both violent and "white-collar" crimes. He also stated that there are three main ingredients that are essential for well- functioning legal system in market economy. They are: a supply of market-friendly laws, adequate institutions to implement and enforce them, and a demand for those laws from market participants. Effective legal reforms are seen as priority for successful transition process and they are inextricably linked [10].

Legal system was one of the original reforms of Washington Consensus. Hernando De Soto was one of the first economists that pointed out the necessity of this issue. He made a case for granting secure property rights cheaply to Peruvian informal enterprises. He saw the necessity in allowing businesses to formalize cheaply, as well as assuring the owners that they would benefit from their own investments [18]. Moreover, the owners would have an access to credit and extra capital flows from formal sector. That was a very efficient strategy as it helped to achieve higher tax revenue and generate public interest for opening new enterprises. So, it helped to ameliorate the problems of high unemployment and government debt that were hurtful for most of the transition economies [18]

The second important measure, which is mentioned in Washington Consensus, was to liberalize trade. "Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low rate..." It was very important for the transition economies to start the process of trade liberalization by shifting from quantitative restrictions and replacing them with tariffs. Even with high tariffs, a transition economy was benefiting. Firstly, it allowed collecting extra revenue for the government to cover its debt. Secondly, it allowed countries to be more flexible with imported production in case of demand shocks. Also, tariffs have a tendency to drop with time. In this case, domestic firms have more competition that makes them use their resources more efficiently, so they have more incentive to invest in research and development. These factors promote growth and increase in TFP for domestic enterprises. Therefore, trade liberalization is also an important factor that brings economic benefits during the period of privatization and cannot be ignored. [13]

It could be argued that privatization could bring its positive results even without competition. This can be presented by the oligarchical capitalism in Russia [11]. Privatization in Russia caused a huge inequality. World Bank found that 77% of inequality increase in Russia could be attributed to growing dispersion of income [20]. Russian privatization was a very "unique" phenomenon. There is a belief that the oligarchs were able to arise only because of "loans-for-shares" auctions held in mid-1990 [11]. These auctions were seen as the most scandalous in

Russian privatization period. The government was "distributing" the assets to its insiders. Special institutions appointed commercial bankers to run auctions that would distribute the stakes of large enterprises in exchange for loans to the federal government (that would not be repaid in most of the cases). The auctioneer was awarding a stake for himself for a bid slightly above the reservation price and was excluding all outside bidders. Then, the stakes were given to the "appointed" people [8]. That resulted a very interesting statistics: by 1996 71% of Russians owned 3.3% of financial assets, 5% of "wealthy" Russians owned 72.5% of assets (among them 2% of "extremely wealthy" Russians owned 52.9% of all financial assets in Russia) [1].

Coming back to the argument, the overview of Russian privatization shows that there was a lack of market competition in the largest sectors of Russian economy. However, it came to be beneficial for the country. Guriev and Rachinsky argued that Russian oligarchs improved firm performance. Firstly, the effectiveness of companies was much higher in terms of achievement of corporate objectives. Oligarchs were the majority shareholders in their companies. Therefore, they did not have a strong incentive to strip out the assets of the company as it was done in companies with dispersed ownership. Oligarchs were seeking to improve the value of their assets.

The positive results could be seen from the audited financial statements of some of oligarch-owned companies. Yukos' assets soared from $5.3 billion in 1998 to $14.4 billion in 2002. Norilsk Nikel's assets increased from $6.6 billion to $9.7 for the same period [11]. Secondly, most of these big corporations were vertically integrated and that helped to solve most of hold-up problems. That eliminated transaction costs between the departments and made the companies more efficient: most of the major oil companies were both extracting oil and delivering it to the final buyer. Blanchard and Kremer in their work mentioned that the hold-up problems of small companies due to Soviet industrial countries were one of the reasons why output has fallen in Russia considerably during the transition period [2].

Thirdly, during the transition, Russia got stuck with underdeveloped financial markets. It was almost impossible to get a loan from a bank for a small or middle-sized firm because of the high level of risk and low level of bank capitalization. Therefore, it worked as a barrier to entry for smaller firms. That was not a problem for the large holdings owned by oligarchs because they had enough internal capital to sustain their operations and even investments [15]. Last but not least, in one of the arguments above it was mentioned that the legal system was one of the most important factors to make the transition process successful. Most transition economies, especially in CIS lacked a clear rule of law.

Russia was no exception. Larger conglomerates were much more effective in influencing judicial and political reasons and protecting their property from the predatory "grabbing hand" of federal and local government [15].

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4. Conclusion

To conclude, the analysis of the positive outcomes of competition was limited to the certain factors, so it cannot be fully objective. However, it is certain that the free market is more efficient in allocating scarce recourses than the command economy mechanism. The economic improvement was seen only with years after the start of the transition process.

In the short run, competition mostly caused the negative outcomes of privatization: high unemployment, job insecurity and lower incomes, increase in shadow economies due to the poor property rights (especially in CIS), damage of infant industries due to market liberalization and etc. In the long-run however, competition gave some positive results as increase in business efficiency, higher business revenues as well as higher incomes of employees, increased trade and decrease in shadow activities within the economies.

Also, it is necessary to mention the other factors that allowed the process of privatization to be more "smooth": improvement in legal factors and trade openness (due to the increase in government revenue). The case with Russian oligarchy can be seen as an outlier and the conditions of market economy development with lack of competition may not work in other countries. Overall, I believe that competition was not just bringing some positive effects of privatization; it was the main source of positive outcomes for the transition economies that could be seen after a certain period of time.

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