

# BSM906

# Economic Environment of Business

Lecture 8  
Transition to a market economy

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# Microeconomic transition

## Key elements

- Restructuring
  - Firm objective (social objective vs. profit objective)
  - Incentives for and constraints on managers (ownership changes)
  - Legal and institutional arrangements for corporate governance
  - Efficiency of capital markets
- Reallocation
  - Rules and institutions affecting entry, exit and bankruptcy (competition)
  - Competition and trade policy
  - Legal structure involving contracts and laws that ensure enforcement of these contracts
    - What is the nature of the key hold up problem in the early stages of transition?
    - What is the impact of institutional development on firm boundaries?

# Key element

## Ownership – I: the key issues

- Property rights view of private ownership
  - Overcoming freerider/commons problem
  - Incentive to invest and monitor contracts
- Agency view of private ownership
  - Divergence of objectives of owners and managers, and freerider problem if firm is widely held (state ownership is an extreme case)
  - Alleviation of manager-vs.-owner agency conflict if ownership is concentrated
  - Possibility of expropriation of minority shareholders and other stakeholders if controlling shareholder-managers are entrenched, especially if there is divergence between cash flow rights and control rights
- Necessary supporting institutions
  - Efficient capital market
  - Rules and regulations that facilitate takeovers
  - Creditors' rights and interventionist creditors

# Key element

## Ownership – II: privatisation in CEE and CIS

- Auction or public tender
  - Difficulties with valuation
  - Political pressures against sale to foreign investors, resulting in sales to insiders such as managers and workers (in Russia, in 1994, majority shareholding in 75% of privatised firms in the hands of insiders)
  - “Golden” residual shares in the hands of the state (e.g., Russia)
- Restitution to former owners
  - Difficulties with estimation of the extent of compensation (especially since common pool resources were being distributed to private individuals)
  - Legal complexities
  - Access to capital and managerial/entrepreneurial expertise
- Mass (or voucher) privatisation
  - Dispersed ownership and freerider problem (role of privatisation funds)
  - Access to capital and managerial/entrepreneurial expertise

# Key element

## Ownership – III: soft budget constraint

	1991	1994	1997	1999
Belarus	8.7	6.3	1.3	5.6
Bulgaria	2.0	1.3	0.8	1.5
Czech Republic	6.4	7.1	7.8	7.7
Estonia	1.5	0.9	0.3	6.9
Georgia	--	13.8	1.5	2.1
Hungary	6.6	5.9	4.9	4.8
Latvia	--	0.2	0.4	5.5
Lithuania	1.4	1.7	0.9	--
Poland	3.3	1.2	0.8	0.4
Romania	13.0	3.8	2.6	1.9
Russia	--	8.1	8.2	5.3

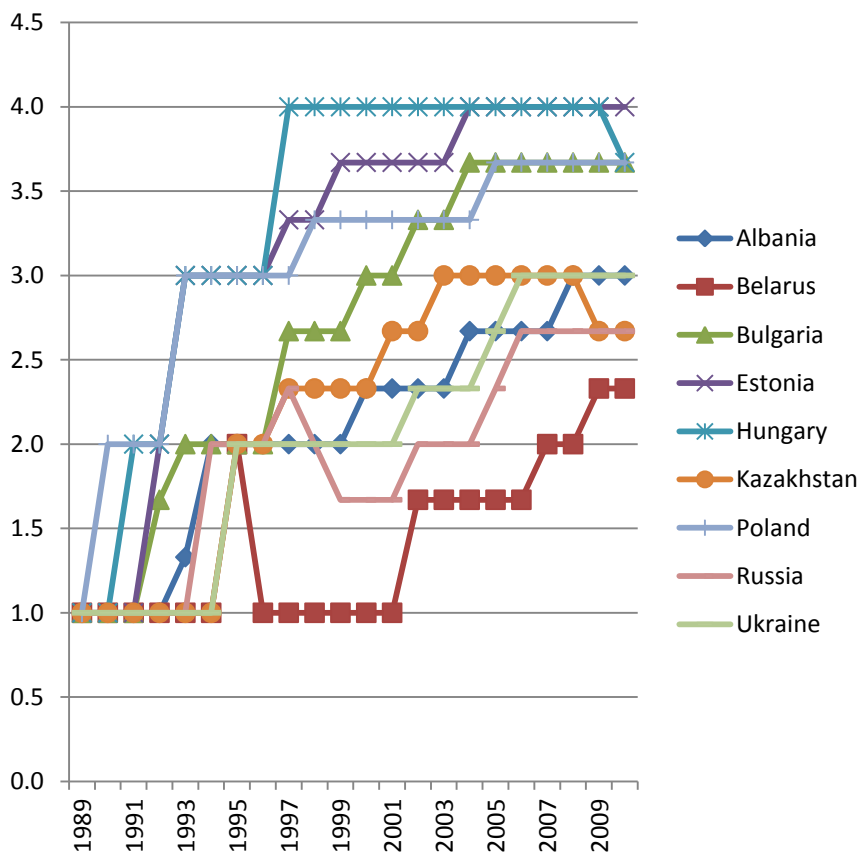
Note: Budgetary subsidies to firms (Percentage of GDP)

Source: Estrin, Saul (2002). Competition and corporate governance in transition, Journal of Economic Perspectives, Vo. 16, No. 1, pp. 101-124, Table 5, pp. 119.

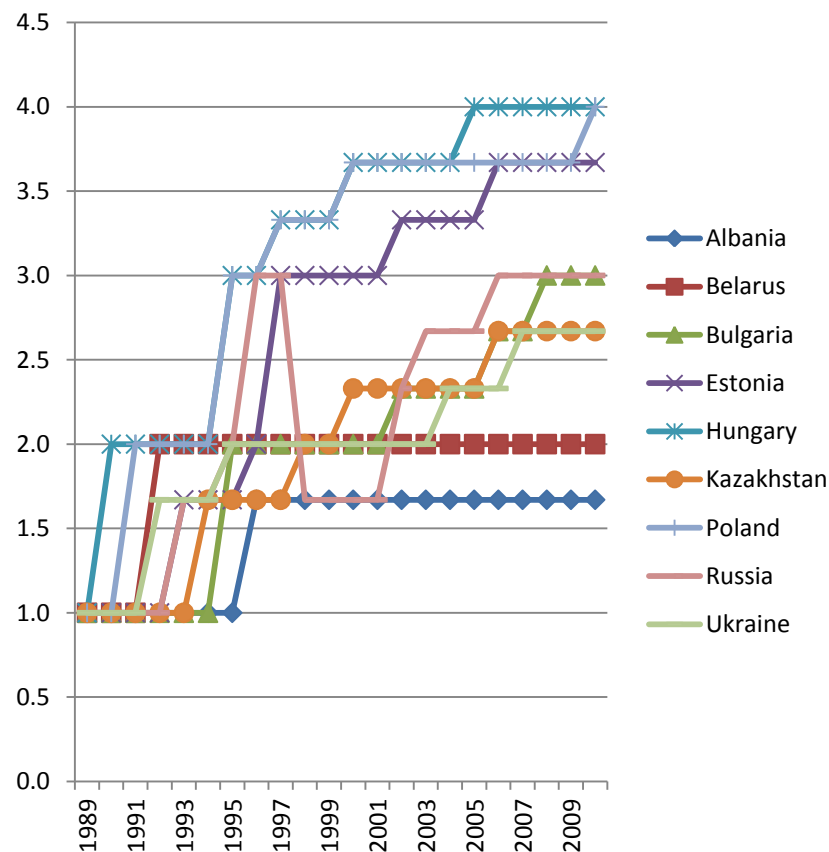
# Key element

## Ownership – IV: supporting institutions

### Banking reform & interest rate liberalisation



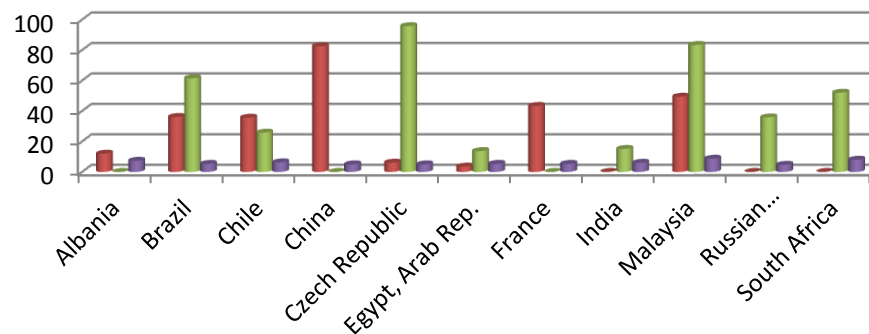
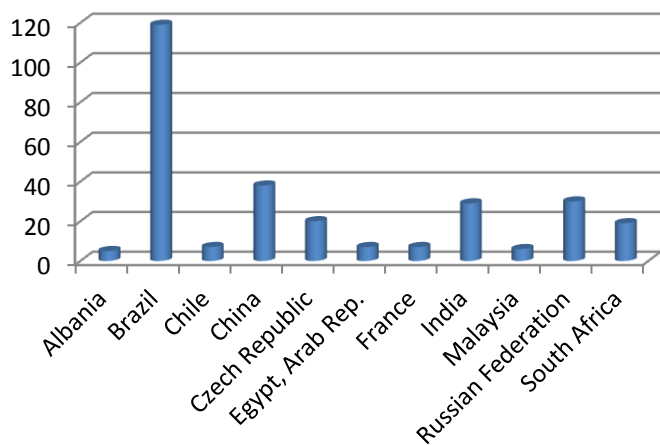
### Securities markets & non-bank financial institutions



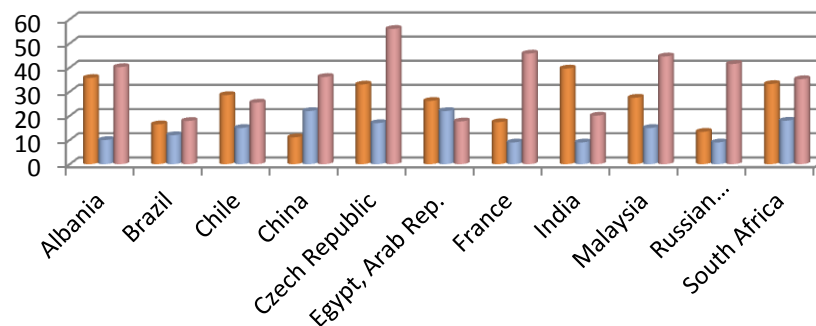
# Key element

## Restructuring: entry, exit and bankruptcy

Starting a Business - Time (days)



Getting Credit - Public registry coverage (% of adults)  
 Getting Credit - Private bureau coverage (% of adults)  
 Protecting Investors - Strength of investor protection index (0-10)



Enforcing Contracts - Cost (% of claim)  
 Resolving Insolvency - Cost (% of estate)  
 Resolving Insolvency - Recovery rate (cents on the dollar)

# Impact of institutional change in CEE and CIS

## Empirical evidence

- Privatisation is strongly associated with better firm performance in CEE but not in CIS
- State-owned firms perform worse than all other firms, except for worker-owned firms
- Interestingly, partially privatised firms perform better than both worker-owned firms and firms with dispersed ownership
- Product market competition had significant impact on firm performance, but the nature of the impact may have been different for firms that were operating close to global standards and those that were quite some distance away from the global standards



# Other approaches to transition

## The Chinese way

- Remediableness
  - Changes are incremental
  - Central leadership endorse successful experimentation at the local level
  - Transparent protection of the economic welfare of all the relevant parties
- Institutions
  - Quotas and controlled prices for infra-marginal production and free markets for above-plan production
  - Decentralisation of property rights, with regional governments “owning” town-village enterprises, and with central government receiving fixed remittances of taxes
  - Credible commitment about non-predation of financial wealth, by way of “anonymous banking”