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...FREEDOM MATTERS

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SOS, SOEs!

In a perfect world, the state would not find it necessary to interfere in market activities nor have a mandate to do so. However, since we are far from an ideal situation, we must make do with what we have. And what we still have in Eastern Europe are state-owned enterprises (SOEs).

Being the advocates of a free market unhindered by state actions, we come with a heavy heart a heavy heart to see how governments try to get involved in market economy when it is not a necessity but rather the will to satisfy its own needs. It is therefore our belief that any endeavors that may limit business operations in the private sector shall be carefully followed to prevent the potentially negative effects of regulation.

Any attempts of the state to sustain the existing SOEs at all costs or create new ones when they are not needed are likely to lead to pathologies – from governments seeking power or leverage, or serving as a safety net for politicians seeking refuge from the political center stage.

Thus, although not envisaging a seventh heaven any time soon, the seventh issue of *4liberty.eu Review* is an attempt to give an overview of the existing practices employed by governments in SOEs and find possible solutions to make their operation less inconvenient for businesses and less prone to abuse of power by the ruling politicians. It is therefore our hope that by giving you these 10 articles written from various perspectives, the reader will have a chance to see why it is crucial to open a wider debate on the issue on an international level. And to do it now.

Olga Łabendowicz
Editor-in-Chief of *4liberty.eu Review*
Coordinator of 4liberty.eu network

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SOS, SOEs!

Governments in Business and the Fate of De-Etatization

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KRASSEN
STANCHEV

Milton Friedman once remarked that "you must separate out being pro-market from being pro-business", and continued: "the two greatest enemies of the free enterprise system, in my opinion, have been on the one hand my fellow intellectuals, and on the other hand, the big businessmen – for opposite reasons".

Today, it seems, the governments of new Europe are often "pro" their involvement in business – directly through state-owned-enterprises (SOEs) or indirectly through regulating entry and exit into markets.

The specific problem of post-communist Europe is that, not too long ago, reform leaders succeeded in forcing the governments out of direct, firm-level involvement in economic activities, and simplified tax and quasi-tax ("business environment") regulations to unleash private initiative and prosperity. The philosophy of those reforms, as far as I can judge as a participant and witness, was no fancier than Smith's "peace, easy taxes, and a tolerable administration of justice" (1955). The individual application of that philosophy was a challenge, but the processes were relatively similar, as one can read in this volume.

As recently as 27 years ago, government enterprises typically contributed to above 97% of the individual countries' GDP. Today, only Cuba and North Korea are in that situation. By 1998, new Europe's average government share in GDP was reduced to 40%, and to 20%-25% by 2010. The progress, besides in Croatia and Slovenia, with 30% and 40%, respectively, was so significant that EBRD stopped measuring the ratio.

That was achieved not just by privatization, which in itself was a success, irrespective of the moral criticism at the time (and the still long-lasting attempt to accuse and take legal action against privatizers). The underlying process was one of de-etatization of the economies.[1]

> "SINCE 1996, NEW EUROPE COUNTRIES MOVED FROM THE RANKS OF "SOMEWHAT" FREE TO ECONOMICALLY FREE COUNTRIES, SCORING MOST OFTEN AMONG THE TOP 50 MOST-LIBERATED ECONOMIES

The process was profound and multi-faceted. It included all types of privatization that economists ever invented: a broad-scale restitution of previously nationalized factories, land, and forest, an equal treatment of the remaining public and private firms, of foreign and domestic investment and workers, an early elimination of price controls and subsidies, of export-import privileges, restrictions, and

[1] The controversies of the process in my country I summarized in: Krassen Stanchev, Political Economy of De-etatization in Bulgaria (available at: http://ime.bg/pdf_docs/02.pdf) but first published as "The Political Economy of Denationalization in Bulgaria" in Suedost Europa, Vol. 53, 2005, Heft 1, S. 80-95.

duties, and at least partial privatization of pension systems, health care, and education. All those tremendously improved the business climate, best measured by levels of economic freedom. Since 1996, new Europe countries moved from the ranks of "somewhat" free to economically free countries, scoring most often among the top 50 most-liberated economies. Some of them, like Georgia and Estonia, even lead globally. The full restoration of private property rights and economic political freedoms has led, in Adam Smith's words, to the "comfortable administration of justice", still not the best in the world, but inducing prosperity.

As a result, the countries are already in the "club" of richer countries (the upper segment of the "middle-income" economies), real GDP per capita increased no less than four times, individual economies' share in global exports jumped about seven times on average, and even the "poorest" of these economies, that of Bulgaria, is richer than 76% of the countries in the world. No surprise that our countries attract economic migrants from all over the world.

Against this unquestionable progress, there are signs of political regression to habits of the past. That regression is based on scattered attempts to get government and politics back in business with nationalizing pension schemes, limiting judicial independence, benefiting existing (and creating new) national champions, and even re-nationalizing some activities and companies.

This volume of *4Liberty.eu* looks at those signs from a broad political and economic perspective. Our approach is different from that of the recent EU Commission's Institutional Paper on "State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context" (July 2016). The authors are not limited by diplomatic correctness and look at the microeconomic and politico-economic essence of anti-reforms in their respective countries.

The overall situation, if we go back to Friedman's remark, is that the intention of governments to be pro-SOE poses a threat to the pro-market foundations of the prosperity of our countries. Both intellectuals and SOE-interested parties advocate such backward political developments.

One of the major concerns of the authors is not only to explain how limited (but still significant) pockets of SOEs and government ownership (mostly in energy, oil, transport, and municipal sectors) impact economic policies. They also highlight the negative spill-over effects on transparency, the rule of law, and overall political order. Besides the reconstruction of history and descriptions of current individual country challenges related to SOEs, the authors of the volume venture into recommendations on how not to recreate (in Germany or in Georgia) the economic and political evils of the past.

Those recommendations are not for governments and politicians, but for reform-minded and entrepreneurial members of the public on what they should demand from their elected representatives. However diverse the countries we cover, one can borrow insights from others' experiences. ●

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The Slovak State as an Entrepreneur

*
MARTIN
VLACHYNSKÝ

The first 16 years of the post-1989 period in Slovakia can be described as an era of privatization. A majority of the state-owned economy was transformed into a market-oriented model, where state-owned enterprises (SOEs) remain the only key player in several sectors.

HISTORY OF SOEs IN SLOVAKIA

Unlike Hungary and Poland, where certain forms of private ownership (especially in agriculture, the service sector, and crafts) were revived during the 1970s and 1980s[1], the state and collective organizations held almost 100% control of all legal economic activities in Czechoslovakia before 1989.

After 1989, the Czechoslovak government decided for a "shock" transformation instead of a gradual one, which included rapid privatization across most of its sectors. The majority of SOEs had been privatized in the 1991–1995 period, either by auctions, direct sales, or a voucher system.

Auctions and direct sales of smaller enterprises (hairdressers, pubs) often involved employees, while the big companies were usually sold to persons with strong ties to the government.

The voucher system offered all adult citizens a chance to buy (for a rather symbolic price) one "voucher book" and allocate the vouchers to desired companies (the transactions were cleared in several rounds of auctions), then becoming a shareholder. In almost all cases, 100% of the ownership was transferred. What remained was a handful of big utility companies, rail and bus companies, the mail, and several dozen smaller companies, usually with some specific function (airports, hospitals, testing centers). The majority of new owners were Slovak nationals, with few exceptions.

The second wave of privatization came with two reform governments at the beginning of the millennium. In the 2002–2004 period, part of the stakes in the utilities was sold to foreign investors. The state usually kept 51% of shares, but surrendered managerial control to investors. Privatization of 17 regional bus companies started in the mid-1990s, and was finished a decade later.

With the change of government in 2006, the attitude towards privatization altered. Besides intensive rhetorical condemnation of the previous privatization, the ongoing privatization of Bratislava Airport and CARGO (rail freight transport) was abandoned. Besides accusations of selling companies under the market price, the center-left coalition with strong populist elements lamented about the loss of state influence in the economy. Paradoxically, the minor coalition partner HZDS had been the main driver behind the notorious 1994–1998 privatization period.

In 2009, the government prepared a law about "strategic companies", giving the government the right of the first buyer for "strategic companies" in bankruptcy. It has not been used since.

The topic of "strategic companies" with a twist resurfaced with the new government in 2016. The 2009 law was aimed at struggling private companies (motivated by then-current troubles of a big employer in central Slovakia), but the 2016 bill was aimed at the SOEs. The law would ban privatization of "strategic companies" (mainly utilities), but has not become reality yet. The only major privatization since 2006 was the sale of the remaining 49% of Tel-

[1] See: Martin, R. (2013) *Constructing Capitalisms: Transforming Business Systems in Central and Eastern Europe*, New York: Oxford University Press, p. 75.

ecom shares to the majority holder in 2015. In the opposite direction, the government recovered 49% of the SPP parent company of the Slovak gas holding[2] in 2014 and owns a 100% stake. Two main reasons were voter appeasement ("the family gold returns!" rhetoric) and more direct control of gas prices for domestic users. Interestingly, the recovery was deemed beneficial also for the private investor by some analysts because the investor remained 49% owner of the highly profitable daughter companies (especially Eustream gas transit company), while the share in loss-generating[3] and politically sensitive mother company (due to selling to the households) went to the state.

The first wave of privatization is considered very controversial. The big industrial companies especially were quickly drained of any valuable assets by their new owners and many of them collapsed. Where the smaller "voucher" shareholders were involved, these were usually squeezed out by bigger players, thanks to the poor rule of law in financial, accounting, and holding matters.

The second wave proved to be much more successful, largely due to the different political environment. The privatized shares became a part of respected international corporations (Enel, GDF Suez, and Deutsche Telecom, among others) and the companies show sound results. In several cases, some concerns were raised about either the selling price being too low[4] or the processes being influenced by corruption [See Table 1].

Table 1. Selected characteristics of Slovak Republic

Characteristic	Size	Year	Source
GDP	EUR 80.96 billion	2016	Statista.com
Number of employees	2 512 700	2016	Statistical Office (SK)
Number of public employees[5]	128 000	2015	Statistical Office (SK)
State budget revenue/GDP	18%	2016	The State Budget Act 2016
State investment/Total investment	27.4%	2016	Eurostat

THE CURRENT STATE OF SOEs

The majority of SOEs were formally booked in the "state company" special legal form in the 1990s. That legal form posted a number of restrictions on management (limited ability to transform assets being one of the foremost) so they were gradually changed into standard legal forms, especially unlisted joint stock companies. Today, the "state company" form remains in about a quarter of Slovak SOEs – the majority of them are in the agricultural and forestry sectors.

Most of the companies to be privatized were then transferred to the special state equity fund "Fond národného majetku" (National Assets Fund) or FNM, which was responsible for the formal side of management and privatization. In the first wave of privatization (until 1998), the fund privatized assets with book value of about SKK 103 billion (about USD 2.9 billion in 1998, or about EUR 7 billion in 2017). However, without open competition for the state assets, there was no way to find the market price of these assets. The assets were privatized for about SKK 30 billion, out of which only about 17 billion was actually paid. Later, the fund held around EUR 2-3 billion (EUR 2.3 billion in 2011) of assets. SOEs not intended for privatization have been formally held under ministry ownership. Ministries are also the responsible shareholders in the companies where private investors hold managerial control, despite having a minority ownership. The Fund was finally disbanded in 2016, since the main role of the fund was to facilitate "mass" privatization. The remaining SOEs in its portfolio were transferred under ministries.

> NONE OF THE SOEs IS LISTED ON THE STOCK EXCHANGE. IN A TYPICAL "CHICKEN OR EGG" DILEMMA, THIS CAN BE BLAMED ON THE EXTREMELY SMALL SIZE OF THE BRATISLAVA STOCK EXCHANGE, OR VICE VERSA

In 2015, 11 ministries and two governmental agencies were shareholders or owners in 65 SOEs. In 59 of those, the state held majority ownership (but in four companies from the energy sector, the minority stockholders hold managerial rights). In 56 of them, the state held over 95% of the shares. Total book value of equity in those companies is EUR 19.4 billion, and equity weighted by share is EUR 16 billion. The majority of equity is concentrated under the Ministry of Transport (EUR 6.6 billion weighted equity) and the Ministry of Economy (EUR 5.3 billion weighted equity). The biggest holdings are the National Motorway Company (100% of EUR 3.5 billion equity), SPP – Slovak Gas Industry (100% of EUR 2.6 billion[6]), and Railways of the Slovak Republic (100% of EUR 1.6 billion equity).

Slovak SOEs employ more than 60,000 employees (some of the smaller companies do not publish an official number of employees), comprising about 3% of all employees in the economy. The three

[2] The SPP is now a 100% state-owned gas supplier in Slovakia both to domestic and industrial consumers (the market is open and there are more than 20 other suppliers, yet SPP has by far the biggest market share). It is also a holding company with an array of gas storage, distribution, and transit companies. However, in those it holds only a 51% stake and no managerial control. The 49% stake and the managerial control are held by a private investor, which is currently the Czech company EPH.

[3] There is some dispute about the financial viability of selling gas to households, since the holding does not officially publish separate numbers for this activity. Most experts consider it money-losing, or zero-profit activity at best.

[4] The privatization shenanigans around the power generator, gas company, and others were the core of the Gorilla Scandal. https://spectator.sme.sk/c/20042075/slovak-politics-gripped-by-gorilla-file.html

[5] In the narrow sense: excluding teachers, police, and municipal workers.

[6] SPP is a holding with a 51% stake in a number of energy companies in Slovakia. The remaining 49% in daughter companies is held by private investors who hold managerial control.

Table 2: Ten biggest employers in Slovakia in 2016

Company	Industry	Number of employees
Železnice Slovenskej republiky (Slovak Railroads)	Railways/Infrastructure	14 009
Slovenská pošta (Slovak Post]	Post	13 446
Volkswagen Slovakia	Automotive	12 300
Tesco Stores SR	Retail	10 100
U.S. Steel Košice	Steelmaking	10 093
Schaeffler Slovensko	Bearings	9 492
Kaufland Slovenská republika	Retail	6 195
ZSSK (Railway Company Slovakia)	Railways/ Passenger transport	5 967
Cargo Slovakia	Railways/ Cargo	5 932
Lidl Slovenská republika	Retail	4 000

Source: Individual annual reports

rail companies and the Slovak Post employ around 40,000 of them. Significant employers also include the state health insurer (2,000 employees), the National Highway Company (1,500 employees), and the co-owned power generation and electricity distribution companies (more than 5,000 employees in 4 of them) [See Table 2].

None of the SOEs is listed on the stock exchange. In a typical "chicken or egg" dilemma, this can be blamed on the extremely small size of the Bratislava stock exchange, or vice versa. In 2016, an idea to create an "energy holding" emerged within the government. The holding would concentrate all its stakes in energy utilities, which are the most valuable SOEs in market-value terms. The realization of the idea is uncertain, due to a potential clash with the unbundling rules of the EU and potential power struggles in the government.

STATE OWNERSHIP, IN THEORY

The problem of SOEs encompasses several fields of economic theory – property rights theory, contract theory, agency theory, transaction theory, incentives theory (principal-agent problem), and, of course, firm theory[7]. Empirical evidence shows that, around the world, SOEs tend to be underperforming privately-owned enterprises[8].

The underperformance of SOEs stems from several sources. There is often a different incentive structure (both formal and informal) in place, which motivates managers of SOEs to divert from chasing economic performance indicators and instead push employment indicators or price rigidity[9]. HR and leadership management often resemble the bureaucratic style of management[10] found in public offices. State ownership often results in problems in defining the targets of the company[11]. Also, innovations in SOEs seem to be less effective and less oriented toward market application[12]. The principal-agent problem and insufficient definition of property rights are obvious implications in this case since the shareholders are (depending on the point of view) either politicians (with a very limited long-term view due to political cycle) or the public (with very limited and delayed voting rights via a democratic election).

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7 See: Peng, M.W., Bruton, G.D., Stan,C.V., andY. Huang (2016) *Theories of the (State-Owned) Firm,* New York: Springer Science+Business Media. https://www.researchgate.net/profile/Yuanyuan_Huang12/publication/301793251_Theories_of_the_state-owned_firm/links/572c12b708ae2efbfdbddfb1/Theories-of-the-state-owned-firm.pdf

8 See for example: Megginson, W.L., Price, M.F., and J.M. Netter (2001) "From State To Market: A Survey Of Empirical Studies On Privatization", *Journal of Economic Literature* Vol. 39, No. 2 (June), pp. 321-389, https://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/1929649.pdf or Djankov, S., and P. Murrell (2002) "Enterprise Restructuring in Transition: A Quantitative Survey", *Journal of Economic Literature* Vol. 40 (September), pp. 739–792, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.319.411&rep=rep1&type=pdf

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WORST PRACTICES IN THE RECENT SLOVAK HISTORY

Taking into consideration the abovementioned theoretical drawbacks of SOEs, we have identified several real-life implications for many Slovak SOEs:

- General economic underperformance;
- Seriously delayed innovations and slow/non-existent reactions to market changes;
- Lack of a pro-client approach;
- Orientation on political goals (employment, product price rigidity);
- Low transparency and responsibility of management;
- Quasi-bureaucratic internal organization;
- No long-term strategy concerning SOEs.

While the dark times of the worst practices in managing SOEs would be in the early 1990s, when money and assets were syphoned out of the companies in broad daylight, we will focus on the examples post-2006 because the government (and its attitude toward governing SOEs) remained largely unchanged since then, with a brief exception (2010-2011, when a center-right government ruled briefly).

1. Rail freight cargo

After splitting the integrated railway monopoly into a passenger transport company, a cargo company, and an infrastructure company, Cargo was put under privatization in 2006. A buyer was confirmed, offering EUR 520 million for the company.

However, after a government change in summer 2006, the privatization deal was abruptly canceled. The company had

> THE NUMBER OF SLOVAK MEDICAL SUPPLIERS ARE KNOWN TO HAVE STRONG TIES TO THE RULING PARTY

been losing market share due to private competitors (as a consequence of EU-desired market liberalization). After the global crisis hit Slovakia in 2009, Cargo started to quickly accumulate crippling losses (almost EUR 130 million in 2009), but the government prohibited the company from reducing its employee numbers. The company with 10,000 employees was bailed out by the government for EUR 166 million in 2009.

Nevertheless, that helped only for a short time. In 2013, the government announced its plan to sell the majority of tangible assets (wagons and depots) to private buyers in order to raise EUR 200 million for the company and subsequently lease them back. Currently, the accumulated loss reaches EUR 400 million. While the company was able to turn mild profits in the last few years and shed 4,000 jobs, its future remains uncertain.

2. Airport Bratislava

A small regional airport, serving mainly low-cost carriers (especially Ryanair) and charters, was subject to privatization in 2006, with a similar story but a less-dramatic conclusion.

> STATE INVESTMENTS TURN THE TAXPAYERS INTO INVOLUNTARY “ENTREPRENEURS”

A consortium, which included Vienna airport (70 kilometers away and connected via a highway), offered EUR 240 million, including investments. The offer was declined after a government change. Instead, the state invested EUR 70 million directly and another EUR 50 million as a loan to build a new passenger hall, raising the annual airport capacity to more than 5 million passengers.

In the next year, the airport started experiencing a massive decline in the number of passengers (40% between 2008-2014), bottoming out at fewer than 1.4 million passengers in 2014. The airport has recorded a net loss for eight consecutive years. Despite a partial recovery in passenger numbers, revenues stagnate. Moreover, the airport lost the opportunity to team up with a strong international partner.

3. The state health insurer VŠZP and state hospitals

Slovakia has an obligatory contributions-based[13] health insurance system with two private insurers and one public insurer with 64% market share. However, due to chronic financial problems (a continuous loss generation) of public health care providers, the state insurer has been under political pressure to increase payments.

The insurer first got into trouble in 2010, recording a loss of EUR 120 million. The situation repeated in 2016, when an audit discovered wrongly calculated reserves that meant a EUR 78 million and EUR 112 million book loss in 2015 and 2016, respectively. Since the private insurers have been facing similar payment conditions (with the market leader driving up payments also for competition), a large part of those losses has to be accounted for mismanagement and poor efficiency.

> THE POWER GENERATOR SLOVENSKE ELEKTRÁRNE (33% OWNED BY THE STATE) IS FORCED TO PURCHASE COAL FROM THE MINE FOR ITS HIGHLY INEFFECTIVE THERMAL POWER PLANT LOCATED NEARBY

[13] After removing the contribution ceiling in 2017, the contributions scheme is literally identical to a tax scheme.

The history of the insurer is littered with a number of payment scandals (for non-existent or dubious care or overpriced material) and the number of Slovak medical suppliers are known to have strong ties to the ruling party.

THE STATE AS AN INVESTOR

An important part of the state's involvement in the private sector is through the facilitation of investments. As already suggested in the story of Bratislava Airport, the state is often a poor investor. The motivation to invest tends to be painfully short-sighted, often focusing on political (the promotion of tangible "achievements") or immediate economic (GDP and employment generated during construction) or financial (business for allied suppliers) gains. State investments turn the taxpayers into involuntary "entrepreneurs".

> WHILE THE NUMBER OF SOEs IN SLOVAKIA IS NOT VERY HIGH, THERE IS STILL A LARGE POTENTIAL FOR ECONOMIC GAINS FROM PRIVATIZATION

There have been several cases of intended investments which stand out. They highlight the complete disregard for long-term planning and a lack of sense of economic reality.

Broad-gauge railway. While the Slovak railway infrastructure had been struggling to keep up with western counterparts, a megalomaniac plan for more than 400 kilometers of broad-gauge trans-Slovak railroad emerged in the mid-2000s. A consortium of Austrian, Slovak, and Russian railroads spent several million euros on studies and analyses (most recently in 2015, with the Russia-Ukraine conflict already under way). With the estimated cost of more than EUR 6 billion, it has been closer to a pipe dream than a reality.

Nuclear power plant. Despite four nuclear reactors covering more than 50% of electricity consumption, two more reactors under construction and a chronically low commodity price, various governments have contemplated the construction of a third nuclear power plant for about a decade. Both economic rationality and a solvent investor are missing, but the responsible state company spends millions on projects and land purchases for an intended plant.

In both cases, millions were spent for preparatory studies, despite not having any economic ground for the projects, nor any potential funding source in sight.

CRONY CAPITALISM

The informal connection of the state and several privately owned companies also have to be taken into consideration, as these companies act as quasi-SOEs. The most striking example is the lignite mine in central Slovakia.

Despite being privately owned, keeping the employment level was pronounced a national interest. The power generator Slovenske elektrárne (33% owned by the state) is forced to purchase coal from the mine for its highly ineffective thermal power plant located nearby. Since the power generation from local lignite is extremely costly, the costs are covered by a subsidy scheme.

1. Besides the rhetoric about the importance of job protection (which recently came under fire due to declining unemployment), there is no strategy with quantifiable goals for the coal subsidies, costing about EUR 100 million annually. The media accused the mine owner of bribing government officials in 2015.

2. Intensive campaigns by NGOs, media, and opposition have slowly turned public opinion, but the government remains firm about the subsidies.

INSPIRATION FROM ABROAD

While the number of SOEs in Slovakia is not very high, there is still a large potential for economic gains from privatization. An inspiration can be drawn from several projects which took place in other countries.

> UNIONS HAVE BEEN LESS ACTIVE COMPARED TO THE WEST AND THE UNION STRONGMEN HAVE A LONG AND GOOD RELATIONSHIP WITH THE GOVERNMENT

Deutsche Bundespost. DB, established in 1950, employed 500,000 people in the late 1980s. The state-owned company was broken into three parts (postal service, telecommunications, and banking) in 1995 and floated on the stock market. The state retained only minority shares in the post and the telecommunications.

Royal Mail. The UK state-owned postal service was completely privatized via IPO in four steps during the 2013–2015 period. About 140,000 eligible employees received 12% of the shares, with a market price around GBP 3,000 per capita.

WHAT TO PRIVATIZE IN SLOVAKIA

Three recurrent major obstacles appeared in recent privatization efforts in Western Europe: unfunded liabilities (pension plans[14]), union pressures[15], and political unwillingness. The first two are not very noticeable in Slovakia.

Company pension plans are practically non-existent and while the market value of some SOEs (Cargo especially) may be close to zero, unfunded liabilities are not on the books. Unions have been less active compared to the West and the union strongmen have a long and good relationship with the government[16]. Especially in the case of the post, wage levels

[14] http://www.if.org.uk/2013/09/25/the-privatisation-of-royal-mail-what-about-the-pension-scheme/

[15] http://www.dailytelegraph.com.au/news/nsw/sydney-bus-strike-transport-minister-demands-drivers-get-back-to-work/news-story/af2275fb841b94984d186171cce2888d

[16] There have been only a few cases of noticeable strike actions in the past two decades, concentrating around nurses, doctors, teachers, and railway workers. All of them were concerning wages and working conditions, not a (potential) privatization. Especially during the Smer (social democrats) governments, unions were very cooperative with the government. Only recently (since 2015), new union organizations split from the old ones in several industries (teacher unions, VW company unions) and organized actions.

> THE SP STRUGGLES TO IMPROVE BOTH THE QUALITY OF TRADITIONAL SERVICES AND NEW MARKETS

are extremely low, as is the overall lucrativeness of the job, making strong union action improbable. Yet, of the 10 biggest employers in Slovakia, four are SOEs with a combined workforce of 40,000 (Slovak railroads and the Slovak Post being the two largest employers in the country), which makes around 2% of all employed Slovaks. That makes employment a question of imminent political interest.

Several SOEs could benefit from obtaining substantial private capital. While the left-leaning governments of Smer[17] had been traditionally adamant against privatization, several ministers of the current government, including the minister of health (and previous CEO of the Slovak Post) or the minister of transport, have shown some openness toward discussing privatization. This may also be due to the favorable economic situation in the country, with unemployment plummeting and an increasing shortage of a workforce in some regions. That would mitigate the expected political impact of privatization due to potential job cutting in privatized companies.

[17] There are three distinct periods in Slovak politics. The 1994–1998 period was ruled by semi-autocratic Prime Minister Vladimir Meciar and his center-populist-nationalist party HZDS (and minor coalition partners). In 1998, the two consecutive center-right governments of Mikulas Dzurinda kickstarted the economy and integration process into EU and NATO. The third period, from 2006 until now (with the brief 2010–2011 break of the center-right Radicova government) by Prime Minister Robert Fico and his party Smer and various minor coalition partners. Smer positions itself in the social democratic political specter, but in reality it resembles the populist-nationalist politics, represented for example by Viktor Orbán.

> THE SLOVAK POST EXISTS IN A LIBERAL ENVIRONMENT AND THERE IS NO REASON THE STATE SHOULD HAVE ANY STAKE IN THE COMPANY

1. Slovak Post (SP)

As any other traditional postal service provider, Slovak Post has been facing a continuous decline in the use of traditional services. It has also been losing its monopoly position in various markets, especially packages over 50 grams and hybrid post[18].

The market was fully liberalized in 2012. Company revenues have been stagnating for a decade and it lost more than EUR 20 million from 2010–2012. Today, about 80% of clients come from corporations and other entities.

[18] Hybrid post monopoly was granted in 2008 by the government, then subsequently disputed by the EC until finally, after 7 years of litigating, canceled.

The company managed to improve its financials in recent years. The post reacted to market changes mainly by cutting costs (creating "mobile post offices" in remote areas) or adding additional (sometimes dubious and prone to jokes) services to its portfolio, like selling insurance or drugstore materials. More recently, the SP teamed up with a private mobile phone service provider.

Yet the SP struggles to improve both the quality of traditional services and new markets. Extremely long waiting times, the low utilization of simple technologies (queue ticket machines were introduced in the country's biggest post office only in the beginning of 2017), and the lack of an international network make package and shipping services less competitive with little hope for future improvements without external capital.

The idea to offer SP shares on the stock exchange was proposed in 2015 by the SP CEO, and the new government started contemplating the idea in 2017. The talks are about 5%-30% free float.

Such a small amount of free float may be largely insufficient to attract any substantial investment and introduce a new drive in company management. The Slovak Post exists in a liberal environment and there is no reason the state should have any stake in the company. The social goal of involving the remote areas in the postal network is already secured by the Universal Service Provider scheme. The scheme can be conducted by a privately owned SP in the same manner as today. Guaranteeing a certain part of shares to employees (as in the case of Royal Mail privatization) can improve the position of the common postal worker in Slovakia.

> TO THE BENEFIT OF TAXPAYERS AND PASSENGERS, THE GOVERNMENT SHOULD SET A DEFINITE DEADLINE FOR LINE LIBERALIZATION AND OFFER A SUBSTANTIAL PART OF ZSSK FOR INVESTMENT

Another option to consider is a direct sale to a strong partner who would be able to implement SP in its global operation and open it to new markets. As an example, the partly privatized Austrian Post teams up with a number of local retailers and plans to compete with Amazon on the Austrian market.

2. Cargo and ZSSK

The rail freight transporter was already introduced in the worst practices chapter. The survival of the company is secured for some time due to the sale of its assets. However, the company is

> MISSING THE KEY TOOLS PROVIDED BY THE MARKET – LIKE BETTER-DEFINED OWNERSHIP AND DIFFERENT STRUCTURE OF INCENTIVES – SOEs WILL TEND TO UNDERPERFORM PRIVATELY OWNED ENTERPRISES IN BUSINESS TERMS

completely dependent on its top client, the major Slovak steelmaker US Steel. However, the steelmaker is for sale and securing long-term contracts on the liberalized freight market in Europe (with strong Polish or Czech competitors, as well as smaller Slovak competitors) will be challenging.

A strong partner can be a way forward. In this case, the state has to be ready to accept minimum net revenue from the sale, since the market value of the company is dubious and largely dependent on the value of existing contracts.

The passenger transport ZSSK has been facing a massive outflow of passengers, especially due to higher use of individual transport. Of the last 12 years, only two were profitable for the company. The company is extremely dependent on state subsidies. It held a monopoly on the subsidized lines, but the monopoly was broken in 2013 by a smaller private transporter, which secured a contract with the state on a minor line.

ZSSK have also been facing competition from non-subsidized private rail operators (which hold only a minor share) and also from resurgent bus transport. The service quality is notoriously poor, a fact which was made painfully obvious after the entry of private operators[19].

The governments have delayed liberalization of the subsidized-lines market for years. But once the major subsidized lines are open to bidding from private operators, it might spell quick doom for ZSSK. To the benefit of taxpayers and passengers, the government should set a definite deadline for line liberalization and offer a substantial part of ZSSK for investment.

[19] Czech private operator Regiojet, offered substantially higher quality and travel experience both on a subsidized route (granted one concession in 2012) and on commercially operated routes. Regiojet left the majority of the non-subsidized routes in 2016, accusing the state-owned competitor of intentionally dumping on the commercial market and misusing revenues from the subsidized routes.

3. Bratislava Airport

Despite the "lost decade" mentioned above, the airport is experiencing a growing interest in passengers. Still, the numbers are well below its capacity and financials are stabilized, but not growing. In 2017, a Chinese investor showed interest in purchasing a 30-year concession to operate the airport, and so far, the government has not given the cold shoulder. When a sale of assets is not politically feasible, a lease deal can be a viable alternative.

IMPROVING SOE MANAGEMENT: RECOMMENDATIONS

Missing the key tools provided by the market – like better-defined ownership and different structure of incentives – SOEs will tend to underperform privately owned enterprises in business terms. That, however, does not always result in financial troubles because many of the SOEs hold monopoly privileges. But it comes at the expense of clients, taxpayers, or general economic competitiveness.

Nevertheless, the management of SOEs can be improved. Most importantly, there has been no coherent general strategy for SOEs in Slovakia, with each ministry pursuing its own goals with "their" SOEs. Private ownership should be set as a general rule for the soundness of the economy. State ownership of any enterprise should have clearly defined goals, which shall be measured and regularly re-evaluated to justify the state ownership. If possible, less intrusive tools to secure the goals should be considered (like the use of Universal Service Provider in the case of postal ser-

> SOEs NEED TO BE OBLIGATORILY BENCHMARKED AGAINST RELEVANT PRIVATE COMPANIES AND SIMILAR SOEs ABROAD

vices, or subsidy lines in the case of transport). However, that is the less ideal case, as there is a high danger of a crony relationship.

Internally, SOE management should be selected in a publicly transparent way. The election of the top management (or at least a CEO) shall involve more decision-makers (depending on the context, central government, parliamentary, presidential, or regional bodies or employer associations or unions). Moreover, the management ought to have a set of managerial goals clearly defined in quantitative terms and public (and set before their hiring), whereas their remuneration should be closely bonded to the results. SOEs need to be obligatorily benchmarked against relevant private companies and similar SOEs abroad. Even in situations when EU state aid rules do not apply, there should be no ad-hoc financial bonds between the treasury and SOEs (like emergency loans).

On a more optimistic note, in SOEs where the state waived managerial control despite retaining a majority stake, such managerial methods are to some extent already in place (although not public)[20].

CONCLUSIONS

After the great privatization wave from the 1990–2005 era, the idea of SOEs has been rising in political popularity. Slovak SOEs lack transparency, have deep connections to ruling politicians and their sponsors, and underperform economically. They often resist innovation, both in technology and in business models. That often results in financial problems and in lower customer experience when compared to privately owned companies.

At least two sectors in Slovakia could hugely benefit from new capital and innovations, the postal service and railroad transport. However, in the near future, a wide-scale entry of private investors into Slovak SOEs seems politically difficult. Despite that, at least a substantial improvement of governance methods in SOEs could bring value to clients, taxpayers, and the Slovak economy in general. ●

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[20] The utitlies (co-owned by big western coporations like Enel or E.ON.) employ standard modern managerial procedures.

SOEs in Serbia: Substituting Market Failure with Government Failure

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MIHAILO
GAJIC

Government interference in the market is often justified with claims that government has a fundamental role to deal with market failures to increase total social welfare. In some instances, interference takes the form of state-owned enterprises (SOEs) that produce goods or provide services instead of private companies. However, what is often overlooked is the fact that market failure can be exchanged for government failure, in which total welfare is not increased by government actions, and sometimes is decreased by it. The reasons for this can be numerous: from lack of knowledge, incompetent administration, and political cycles, to corruption and state capture[1].

> ”
> WHAT IS OFTEN OVERLOOKED IS THE FACT THAT MARKET FAILURE CAN BE EXCHANGED FOR GOVERNMENT FAILURE, IN WHICH TOTAL WELFARE IS NOT INCREASED BY GOVERNMENT ACTIONS, AND SOMETIMES IS DECREASED BY IT

In Serbia there is a plethora of possible government policy actions beyond the establishment and operation of SOEs. Having in mind the negative results stemming from the operation of SOEs, to alleviate this problem an approach other than appointing new management is necessary, as might be heard in public discourse.

Serbian SOEs are poorly managed and are used as tools for keeping social peace with unreasonably low prices of services rendered, high wage bills, and low efficiency. SOEs also pose a high fiscal burden (relying on high government subsidies) and fiscal risk (their debt is often taken over by the government due to liquidity or solvency issues).

SOEs IN THE SERBIAN ECONOMY

SOEs have a prominent role in the Serbia economy, employing about 10% of all registered workers. The total number of SOEs is not publicly disclosed, as there are different methodologies in deciding which companies should be included in the list. Therefore, the data regarding their operations – although coming from formal government sources – shuld be taken with a grain of salt, since some of them are contradictory.

Serbian SOEs can be subdivied into several categories:

1. Public enterprises

Two government bodies that supervise the work of public enterprises provide two different figures for these companies. The

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[1] Tullock, G. et al. (2002) *Government Failure: A Primer in Public Choice*, Cato Institute.

Ministry of Economy listed only 37 companies as public entreprises on their website, while the Commissioner for Information of Public Importance and Personal Data Protection listed 137 of them[2]. They employ about 79,000 people[3].The companies have a special status because they are considered vital to the economy or welfare of the population. As such, they must render their service at all costs and cannot go bankrupt because the government must see to it that the service be provided in continuity[4]. The status of a public company is granted by government via by a special sublegislative document; these by companies can function in the form of a limited liability company or a public limited company. However, their shares cannot be traded and their proprietor is the state itself. The Ministry of Economy appoints the managing boards and CEOs in a process that is envisaged to be transparent, but is prone to political pressures. The companies are concentrated in several industries, such as power generation and distribution, natural gas distribution, postal service, national parks, real estate, and rail transport.

2. Municipal enterprises

This group includes about 350 enterprises that operate on the local level and were set up by local governments (cities, towns, and municipalities). They are mostly active in public utilities such as district heating, water supply, and sewage, and employ 67,000 people[5]. Their management is appointed by the local government and their status corresponds to that of central government public enteprises.

3. SOEs

These companies are owned by the government, but they do not have the status of public entreprises. Therefore, they operate in the open market with competition from private companies and are limited liability companies. Some of the companies have shares that are freely traded on the stock market (Nikola Tesla airport, oil company NIS) while some of them, although listed, cannot be traded (telecommunication company Telekom Srbija). Their number is not discernible because they operate as any other company, though their management is appointed by a board of directors, which is in turn appointed by the shareholders (a line ministry in cases where government is the majority owner).

Not all companies are completely owned by the government; some have minority shareholders, and the state may be a minority stakeholder in some cases.

For example, Telekom Srbija (the natonal telecommunication company) has a small number of shares owned by employees and the general public that were administered through a voucher scheme, but the majority is in the hands of the government. The NIS (national oil company) has been privatized to the Gazprom Neft company, but the state has retained a 49% minority share, as in the case of Air Serbia, the national airline company.

[2] The Ministry of Economy uses the legal definition, stating that public enterprises are companies that "provide service of general importance" (Law on Public Enterprises, Official Gazette 15/2016). The Commissioner for Information of Public Importance in its catalog lists all legal entities that were set up or that are being financed fully or predominantly, by the central government (Law on free access to infomation of public importance, Official Gazette 120/2004, 54/2007, 104/2009, 36/2010); the majority of these companies are actually public enterprises since only they are directly financed by the government. The two lists, therefore, overlap.

[3] Ministry of Finance of the Republic of Serbia (2016), *Fiscal Strategy for 2017*.

[4] Law on Public Enterprises, Official Gazette 15/2016, article 14.

[5] Fiscal Council (2017) *Local Public Finances: Problems, Risks and Recommendations*.

WHEN GOVERNMENT EMPLOYEES (ADMINISTRATION AND SERVICES SUCH AS EDUCATION AND HEALTH CARE) ARE TAKEN INTO ACCOUNT, SOEs ACTUALLY EMPLOY ALMOST 15% OF THE WORKFORCE THAT IS ACTIVE IN COMPANIES THAT OPERATE ON THE MARKET

State companies are prominent in many sectors, such as furniture manufacturing, pharmaceuticals, mining, telecommunications, and chemicals.

4. Companies in restructuring and social ownership

This group is something so peculiar that it can be found only in Serbia and former Yugoslav countries. Prior to the privatization process, a majority of companies were in ¨social ownership¨, which was a brand of self-governing socialism present in socialist Yugoslavia. During transition, the companies should have had their ownership status changed, from social to state (through new registration) or private ownership (through privatization).

The process of ownership transformation and privatization commenced with the Laws on Social Capital (1989), Law on Conditions and Procedures to Transform Collective Property into Other Forms of Property (1991), and Privatization Law (1997), which all advocated insider privatization, culminating in the Law on Privatization (2001), which stipulated majority capital sales through tenders and auctions[6].

However, since many of those that were privatized through the selling of capital were later in a legal vacuum since its privatization contracts were terminated (usually because the buyers did not honor their part of the deal, such as paying the full price when paid in installments), they reverted to their previous legal status. Usually, they were in a bad situation and soon entered bankruptcy, which was prolonged to provide a safety net for the workers[7] while their wages were paid through state loans or direct subsidies.

In 2016, there were 220 such companies with 45,000 workers[8].

That shows that the total level of involvement of the state in the market is quite substantial, with about 190,000 employees working in SOEs of different types in various industries, 10% of the total number of

[6] Vujacic, I. et al. (2016) *Privatization in Serbia - an assessment before the last round*.

[7] Some companies spent almost a decade in this bankruptcy limbo, which basically annulled the property rights of their creditors.

[8] Fiscal Council (2016), *Fiscal Trends in 2016, Consolidation and Reforms 2016 - 2020*.

all people employed (1.9 million). However, when government employees (administration and services such as education and health care) are taken into account, SOEs actually employ almost 15% of the workforce that is active in companies that operate on the market.

MANAGEMENT: COMPETENT OR POLITICAL?

The large sector of SOEs, whose role is more prominent than in a majority of other European countries, is a legacy of the socialist economic and political system, and voter preferences.

However, SOEs in Serbia can also be used for political and economic benefits. The political benefits could be in the form of buying popular support (among voters whose preferences are state involvement in the economy or among those employed in the companies), while the economic ones could be embezzlement or corruption, for private or party purposes. SOEs are often regarded as feudal domains, and their ¨allocation¨ to parties in coalition government is unofficially considered an important part of every coalition agreement[9].

One of the surest ways to exploit their operation by political parties is to appoint management liable to pressure from the executive government. That is relatively easy, as the Law on Public Enterprises stipulates that the government appoints the CEOs of these companies, as well as all members of the governing board.

Although there are some legal requirements that were envisaged to disable political pressure[10], they all are easily circumvented. In several cases, CEOs are high-ranking party officials (as in the cases of Galenika [pharmaceuticals], Srbijagas [natural gas transport and distribution], and until recently the Post Office) or people who are not party members but have close personal connections to members of government (electrodistribution company EMS is managed by Nikola Petrovic, who was allegedly the best man in the wedding of the previous prime minister and current president, Aleksandar Vucic).

POLITICAL PARTIES USE MANAGEMENT POSITIONS IN SOEs AS LUCRATIVE SINECURES FOR LOYAL PARTY OFFICIALS

The issue of education qualification is circumvented through corruption in higher education: Party officials have been known not only to buy university diplomas, but also doctorates or even secondary school diplomas when they only have an elementary education. The cases of the former

9 Due to the Serbian election system, coalition governments have been a constant factor of political life in the country (all government since the democratization in 2000 were coalition governments).

10 One member of the board is a respresentative of employees and one is an independent (not a member of a political party); a CEO should resign his position in the party which he belongs to; and there are some provisions regarding the level of education or professional experience of CEOs and that they should be appointed after a public call (Law on Public Enterprises, Official Gazette 15/2016).

Table 1: Non-public[11] vs. public company performance (in billion EUR)

2015	Non-public companies	Public companies
Total Assets	105.5	15.6
Equity	49.5	12.9
Net financial result	1.2	0.1
Return on Assets	1.12%	0.44%
Return on Equity	2.37%	0.53%

Source: Serbian Business Register Agency of the Republic of Serbia, *Financial Statements Annual Bulletin for 2015*, Belgrade, 2016

President Tomislav Nikolic, Belgrade Mayor Sinisa Mali, Minister of the Interior Nebojša Stefanović, and State Secretary in the Ministry of Foreign Affairs Ivica Toncev, among others, are only the most publicly exposed cases.

Apart from those illegal tools to circumvent the Law on Public Enterprises, there are instances when the law is completely disregarded, the best example being the public call for new management. The new law adopted in 2016 stipulated that new management had to be appointed using the new transparent procedure (using a public call, after which a commission composed of members of parliament and state bodies would create a ranking list, where the highest ranking candidate would be appointed CEO) within 12 months or March 2017 at the latest. However, when that schedule had passed, most public calls have not even been published, let alone CEOs appointed.[12]

The current situation in this field shows that political parties use management positions in SOEs as lucrative sinecures for loyal party officials. The loyalty goes both ways: Even if an SOE shows bad business results, the CEO and members of the managing boards would not be dismissed. For example, for almost a decade the CEO of Srbijagas has been Dusan Bajatovic (Socialist Party of Serbia), and during this time the company incurred losses so high that it has lost all of its capital, and transferred more than EUR 2 billion of company debt (equaling almost 7% of GDP) to the government, which is almost 10% of the total government debt. Bajatovic, of course, still operates the company.

Since SOE managers know that their positions are safe only as long as they are loyal party soldiers, and that their results are not crucial, they lack incentives to achieve good business results. Furthermore, the situation is further jeopardized by political corruption. A party takes control of an SOE through the management, which then has to fulfill governing party requirements, such as providing lucrative posts to other party officials and ordinary party members[13].

11 Non-public companies include private companies as well as state-owned companies that do not have legal status of public enterprises.

12 Transpareny Serbia (2017) Late calls for public enterprises CEOs. http://www.transparentnost.org.rs/index.php/sr/aktivnosti-2/naslovna/9062-sporni-i-zakasneli-konkursi-za-direktore-javnih-preduzeca

13 High unemployment of 14%, low job security, and

Table 2: The performance of two biggest telecommunication companies in Serbia (in million EUR)

2016	Telenor Ltd.	Telekom Srbija
Total Assets	405.4	1 590.5
Equity	279.6	1 088.8
Net financial result	73.2	125.0
Return on Assets	18.05%	7.86%
Return on Equity	26.18%	11.48%

Source: Financial statements of respective companies

Another issue regarding public procurements by SOEs, and the corruption stemming from it, are several recent scandals[14] that are still waiting on litigation due to the inactivity of public prosecutors. Although it is hard to claim that corruption in public procurements is only caused by political party involvement, the situation significantly boosts this phenomenon, providing an environment in which corruption by party officials remains unpunished, if not openly encouraged.

INEFFICIENCY, INEFFICIENCY EVERYWHERE!

Although some SOEs operate with high revenues and profit (mostly the national telecommunication company Telekom and the energy company EPS), most of them operate with losses. That can be illustrated with data from the financial registry, which compares the data from financial statements of 485 public companies with the rest of the economy [See Table 1].

It is evident that public companies, overall, are less efficient than private companies. Although 2015 was a good period for public companies because they finally stopped incurring losses, they operate with low profitability. Private sector RoA and RoE are 2.5 and 4.5 times higher, respectively. Inefficieny is also evident in the case of the most profitable SOE, Telekom Srbija, with RoA and RoE approximately 2.5 times lower than that of its main market competitor, Telenor Ltd. [See Table 2].

The causes of inefficiency in SOE operations are found in political appointments to their management. However, the problem is not that board members or CEOs do not possess adequate knowledge (they could always employ experts who could advise them on how to run the company). Instead, the main problem with political appointments lies in the above-mentioned fact that management obeys party headquarters to use SOE resources for political purposes – to stay in power and gain more votes in the next election. That is mostly done by SOEs taking over some elements of social policy through prices and employment.

REALIZING SOCIAL POLICY THROUGH SOEs: PRICES

In the best-case scenario, SOEs should function on the basis of business revenues only. The revenues ought to be high enough to cover all expenses and pro-

lower salaries in the private sector serve as good incentives to seek employment in the public sector, which can be obtained through party memebrship.

[14] For example, rigged tenders for public bus transport in the City of Nis, construction of the railway station Prokop in Belgrade.

Table 3: Electricity prices in Europe

Country	Cents per KWh
Serbia	0.065
Albania	0.082
Bosnia and Herzegovina	0.083
Macedonia	0.084
Montenegro	0.099
Hungary	0.115
Czech Republic	0.129
Romania	0.132
Croatia	0.131
Poland	0.142
Germany	0.295
Denmark	0.304

Source: Eurostat, *Energy price statistics*, available at: http://ec.europa.eu/eurostat/statistics-explained/index.php/Energy_price_statistics

Table 4: Utility water prices in Europe

Country	USD per cubic meter
Albania	0.53
Serbia	0.53
Macedonia	0.54
Bosnia and Herzegovina	0.88
Romania	0.90
Bulgaria	1.06
Montenegro	1.12
Slovakia	1.32
Poland	1.39
Czech Republic	1.67
Croatia	2.16

Source: IB Net (International Benchmarking) database, available at: http://database.ib-net.org/DefaultNew.aspx

Table 5: Number of staff in water utilities in Europe

Country	Per 1,000 population served
Slovakia	0.04
Czech Republic	0.29
Germany	0.32
Denmark	0.35
Poland	0.4
Hungary	0.92
Croatia	0.97
Serbia	0.99
Macedonia	1.08
Bosnia and Herzegovina	1.47
Bulgaria	1.74
Romania	2
Albania	2.02
Montenegro	4.44

Source: IB Net (International Benchmarking) database, available at: http://database.ib-net.org/DefaultNew.aspx

vide for long-term capital investments in infrastructure, especially in utilities. The price policy needs to be efficient; prices shall be defined in such a way as to cover full costs. However, in this manner, state-owned companies would need to set prices that would be much higher than they are today.

Populism through prices for SOE services has a strong legacy from socialist times because the regime tried to make at least some basic utilities affordable for all citizens. It started to be used more frequently during the chaos following the dissolution of Yugoslavia and the economic and social crisis that followed (GDP in Serbia plummeted to less than half of its 1989 level, international sanctions on trade were imposed, and there was one of the highest hyperinflations in the world in 1993). Unfortunately, populism through prices is used to this day. It can be illustrated through comparing household electricity prices (including taxes and levies) among countries in Europe [See Table 3].

DUE TO THEIR INEFFICIENT OPERATIONS, MANY SOEs IN SERBIA HAVE TO RELY ON DIRECT OR INDIRECT STATE AID

It is understandable that Serbia has electricity prices lower than more-advanced European countries because of the higher standard of living enabling their citizens to afford higher prices, and also because of the higher share of renewables in electricity generation, among other reasons.

However, Serbia has much lower prices in comparison even with countries on the same level of economic development measured by GDP per capita such as Montenegro, Macedonia, Bosnia, or Albania. The same trend is visible in water supply and sewage [See Table 4].

REALIZING SOCIAL POLICY THROUGH SOE: OVEREMPLOYMENT

SOEs are used not only for political sinecures, but also to boost total employment in the economy, providing jobs for thousands of people who would otherwise remain unemployed, especially in areas outside of the bigger cities. That can be illustrated by employment figures from financial reports for SOEs that are active in industries where there is no single provider, so their data can be compared to their competition.

Data show that the national telecommunications company, Telekom Srbija, employs eight times more people (8,203 employees in 2016) than its main competitor Telenor (1,033 employees in 2016). Since these two companies are active in the same market and have similar strategies (main income coming from mobile telecommunications, high investments in internet provision, and new ventures in mobile banking) overemployment in the state company is obvious.

For utility sector SOEs that have monopoly status, such comparison is not possible. However, it is possible to compare Serbian utilities with those from other countries. The data show that Serbia is somewhere in the middle of transition countries by the indicator of the

Table 6: Subsidies in Europe

Country	Subsidies in % of GDP
Poland	0.5
Romania	0.5
Slovakia	0.6
European Union	1.3
Hungary	1.3
Euroarea (19)	1.5
Bulgaria	1.8
Croatia	1.8
Czech Republic	2.3
Serbia	2.9

Source: Eurostat, Government Finance Statistics, available at: http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_finance_statistics and Consolidated Public Finance Report of Ministry of Finance (for Serbia)

> SOME SOEs ARE LEGAL MONOPOLIES AND, THEREFORE, DO NOT FACE COMPETITION IN THE MARKET BUT STILL USE LAVISH SUMS OF MONEY FOR ADVERTISING, REGARDLESS OF THE FACT THAT THIS WILL NOT INCREASE THEIR SALES

number of employees per 1,000 population served by water utilities. However, there are several countries where water utility companies are much more efficient within this group – Poland and the Czech Republic have two or three times less staff, in line with the countries from Western Europe [See Table 5].

Several companies could be used to illustrate this overemployment phenomenon. For example, business revenue of the Resavica mining company cannot even cover its wage bill expenses, so the company relies heavily on government subsidies. IKL Jagodina, a company active in the cable production industry, has a peculiar and unsustainable employee structure: Of 1,200 employees, only 400 work directly in production while 800 are administrative workers[15].

FISCAL CONSEQUENCES OF INEFFICIENT SOE OPERATIONS

Due to their inefficient operations, many SOEs in Serbia have to rely on direct or indirect state aid. The direct state aid goes through subsidies that are paid on an annual basis and are visible in the state budget. The biggest share of these subsidies goes to the railway transport company Zeleznice Srbije (almost EUR 100 million every year). However, indirect costs are also substantial, but almost impossible to calculate.

Indirect costs can be classified as tolerated arrears for taxes (in some cases SOEs are among the biggest tax debtors) and utility services (one SOE does not pay its bills for water, heating, or electricity to another SOE). The Government Development Fund often provides liquidity or investment loans with preferential interest rates which are seldom paid back. The Development Fund usually takes part in equity share, which is

[15] Fiscal Council (2016) Fiscal Trends in 2016, *Consolidation and Reforms 2016–2020.*

just an accounting trick since the government is the owner of both entities, so the ownership structure does not change at all.

Therefore, state subsidies in Serbia are much higher than in EU countries or other countries in transition, reaching almost 3% of GDP [See Table 6]. However, those are only direct subsidies, the cash amount paid. The amount does not include indirect supplements, such as paying off SOE state-guaranteed debts, providing loans with preferential rates, resources from discrectionary budget reserves, arrears in paying taxes, and forgone profits — a sum that was estimated by the World Bank mission in 2013 to be around EUR 700 million or 2% of GDP [See Table 6].

SOEs AS ENEMIES OF MEDIA FREEDOM

SOE operations in Serbia are detrimental to media pluralism and freedom as well. Political influence over the media is exercised through marketing and SOE advertising, as evidenced by the report of the Anticorruption Council, an independent state body[16].

In a nutshell, SOE management does not advertise its products or services in the media that are critical toward the government. Furthermore, some SOEs are legal monopolies and, therefore, do not face competition in the market but still use lavish sums of money for advertising, regardless of the fact that this will not increase their sales. That is because their expenses are used as some kind of pecuniary reward for media silence. Another issue is the lavish costs of marketing and PR activities of companies undergoing restructuring. Since they basically survive through direct and indirect government subsidies, the expences are dubious in nature, especially because they go through companies connected by high-ranking political officials (as was the case of Prva petoletka, a TV station that is owned by the wife of Minister of Defense Bratislav Gasic).

All that leads to the situation in which the media do not hold politicians accountable because a large part of their income is derived from SOEs controlled by the same politicians.

CONCLUSIONS

The SOE sector in Serbia is bloated with an oversized staff, inefficient price policy, and controlled by political parties. That causes mismanagement and corruption, leading to inefficient economic outcomes. Therefore, SOEs pose a high fiscal burden of at least 3% GDP directly, and possibly another 2% of GDP through indirect means[17].

All the characteristics of Serbian SOEs prove the claim that possible market failures are supplanted by certain government failures.

To improve the level of services rendered to the public, bold steps in SOE privatiation must be taken. Raising capital investement, and thus the quality of infractructure, and alleviating a heavy fiscal burden stemming from inefficient operations cannot be done in the current system. As some advanced countries prove, providing professional management for SOEs is possible, but necessary preconditions for this development, such as strong and effective public institutions, political accountability, and rule of law, must exist. Serbia, as a country with a high level of corruption, low government efficiency

[16] Anticorruption Council (2015), *Report on the possible influence of public sector institutions on media through marketing and advertising services.*

[17] World Bank, *Republic of Serbia: Municipal Public Finance Review - Options for Efficiency Gains*, 2014.

and political accountability, and a weak rule of law, provides an environment in which government failure is almost an inevitability. It would take decades, if not generations, to build the necessary preconditions to prevent, or at least lessen, government failure in managing SOEs.

Therefore, the only viable solution for an increase in efficiency of SOEs is including the profit motive by their partial or full privatization[18]. That does not necessarily mean no government involvement, as price regulation in certain markets considered to be natural monopolies is still possible, in accordance with EU rules. But such government intervention is much different than setting up and operating a company, leaving much less room for political influence, corruption, and a negative economic impact on society.

POLICY RECOMMENDATIONS

Although the privatization process in Serbia has been plagued with a plethora of misconduct and numerous corruption allegations, privatization is the only short-term way to eliminate political parties from managing SOEs. That alleviates the fiscal burden stemming from high subsidies, and also increases future public revenues through increased efficiency and productivity. Furthermore, the policy would have economic and political consequences because it will provide less room for political clientelism, corruption, and media influence. Thus, the following measures are recommended:

1. Full privatization of all SOEs that operate in competitive markets: Telekom, Galenika, EPS.

2. Liberalization of market segments that are still under monopoly by SOEs (for example, postal traffic).

3. Minority or majority equity privatization of companies operating in market labelled as natural monopolies.

4. Total privatization of the rest of the companies in restructuring. Bankruptcy and closing down of those that cannot be privatized for a lack of interested buyers. ●

[18] Privatization Agency of the Republic of Serbia, *Impact Assessment of Privatization in Serbia*, 2005.

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Anthology of Czech State-Owned Enterprises

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KRYŠTOF KRULIŠ

The state-owned enterprises (SOEs) represent a broad category of entities pursuing commercial activities with the unifying feature of public ownership. This article summarizes the main legal forms of enterprises (state enterprises, national enterprises, and state shareholdings in private companies) through which the Czech state operates inside the economy, and provides important examples in each category. The concluding remarks stress that business operations owned by a public authority are not limited to state, but are also present at regional and local, levels.

> BUSINESS OPERATIONS THAT REMAIN IN THE HANDS OF THE STATE ARE ONLY A FRAGMENT OF FULL STATE CONTROL UNDER THE SOCIALIST REGIME BEFORE 1989

Former structures of the planned economy in the Czechoslovak Socialist Republic reserved all economic activity from retail to manufacturing and provision of services to state enterprises or cooperative organizations.

In the 1990s, the Czech Republic undertook a transformation that resulted in the development of institutions of a liberal democratic state and a gradual opening to private ownership in the economy – partly by privatizing SOEs and partly by liberal treatment and incentives to foreign direct investments.

The central government and other public entities in the Czech Republic (regions, municipalities) are still engaged in benefit provision of the social-market economy (social security, health care, education). According to OECD data, general government spending (indicating whole spending by central and local governments, not only their direct business operations) in the Czech Republic reached 41.6% of GDP in 2015 (slightly more than 41.5% in Poland and slightly less than 42.8% in the United Kingdom)[1]. Business operations that remain in the hands of the state are only a fragment of full state control under the socialist regime before 1989. Nevertheless, this residue of the public operation of business activities still includes strategic enterprises in the energy sector, transportation, and other utilities. This article summarises the main legal forms of enterprises through which the Czech state operates inside the economy and provides important examples in each category.

DEFINITION: WHAT ARE SOEs?
SOEs represent a broad category of entities pursuing commercial activities with a unifying feature of public ownership, in full or partial. The borders of this category are not

[1] OECD (2017), General government spending (indicator). doi: 10.1787/a31cbf4d-en

> IN THE CZECH LEGISLATION, THERE IS A SPECIFIC LEGAL FORM OF A "STATE ENTERPRISE" (STÁTNÍ PODNIK; S.P.)

as unequivocal as it may seem from such a definition – there may be several specific aspects of national law that shape opinions on which entities fit into the SOE category. The legal form of SOEs may vary significantly, from a legal form shaped specifically for SOEs to SOEs existing in a legal form of an ordinary commercial corporation.

STATE BUSINESSES, LEGALLY

In the Czech legislation, there is a specific legal form of a "state enterprise" (Státní podnik; s.p.). That entity could be founded by the state with the consent of the government. It can pursue commercial activity in its own name. It does not own property but it can manage specific state property.

An example of an SEO in this form is the Czech postal service (*Česká pošta s.p.*), which operates 3,868 post offices around the country (including partner offices and postal points of special purposes) and has 29,974 employees[2].

This legal form is also used by enterprises managing five river basins in the territory of the Czech Republic (the Vltava, Labe, Morava, Odra, and Ohře rivers) and an enterprise managing most (around 86%) of the forest areas under state ownership, *Lesy České republiky, s.p.*, which represents more than 1.3 million hectares[3].

Furthermore, the state enterprise form has also been used to found *Řízení letového provozu České republiky, s.p.*, an enterprise managing air traffic services in the airspace above the territory of the Czech Republic in accordance with the Chicago Convention establishing the International Civil Aviation Organization. Finally, *LOM PRAHA s.p.*, is an example of this legal entity used in the defense industry. It has a specific purpose and necessary certificates for general repairs of helicopters of the Mi category (Mi-2, Mi-8/17, Mi-24/35) of the Russian construction in the armies of NATO and the EU[4].

NATIONAL BUSINESS

There is also a specific legal category of the "national enterprise" (*Národní podnik; n.p.*) which is a remnant of the legal forms existing prior to 1992. The only still-existing enterprise in this category is *Budějovický Budvar, n.p.* It is the last brewery that remains under state ownership, mostly for the sake of legal disputes over trademark and geographical identification (more than 40 court proceedings and more than 70 administrative patent cases) that the company wages worldwide with *Anheuser-Busch InBev* and its "Budweiser" brand[5].

STATE-OWNED COMPANIES

This category of state enterprises (supplemented with the remaining example of the national enterprise *Budějovický Budvar*) would not provide a full picture of the state involvement in commercial activities.

Those legal forms are divergent from the ordinary forms of commercial corporations and only the state can found a state enterprise. The state is, however, not limited to those forms. The state can also own shares in regular corporations – in particular, in the legal form of a joint-stock company (*akciová společnost; a.s.*).

In that case, the state has a position of an ordinary shareholder and its decision power depends on its shareholding in the company or specific provisions in the company's articles of association. The state has to follow all the rules for shareholders resulting from company law, e.g., rights of minority shareholders. In the case that the company has its shares publicly listed, it also has to follow all the rules on availability of information for individual investors. The shareholding of the state may be 100% or another majority. Lower shareholdings and smaller portfolio investments without intention to pursue decision powers in the company are also possible. However, in that case it depends on how we define SOEs and if enterprises without state influence over its management should still be considered SOEs.

"PARADE" OF CZECH SOEs

The following companies are examples of the state holding a 100% share:

ČEPRO, a.s. is a company providing transportation of crude oil products in its pipeline network length of more than 1,100 kilometers, connecting its storage capacities with refineries in Litvínov and Kralupy nad Vltavou in the Czech Republic, and Bratislava in Slovakia[6]. It also operates a network of petrol stations under the EuroOil brand. With its 194 filling stations, EuroOil is the third most-numerous petrol station network in the Czech Republic. *ČEPRO, a.s.* is also the sole supplier of petrol offered under the EuroOil brand.

MERO ČR, a.s. is a company owning and operating part of the backbone crude oil pipelines Družba and IKL, situated in the Czech Republic[7]. It is thus the only company with capacity to ship crude oil into the Czech Republic. *MERO ČR, a.s.* is also the biggest provider of storage capacity for the Czech national emergency reserve of crude oil.

ČEPS, a.s. is another pivotal company in the Czech energy network. It is the sole operator of the backbone transmission system for electric energy in the Czech Republic, consisting of 41 substations with 71 transformers that allow electricity to be supplied from the transmission system to the distribution network. The company also operates a total length of 3,508 kilometers of lines in 400kV voltage and 1,910 kilometers of lines in 220kV voltage[8].

Český Aeroholding, a.s. owns the key infrastructure at the international Václav Havel Airport Prague. It is a holding company with shares wholly owned by state[9]. Its wholly owned subsidiary, *Letiště Prha, a.s.*, operates the Prague airport which is, with more than 13 million passengers in 2016, the largest airport among the new EU Member States. It holds shareholdings in other subsidiaries that provide technical and supplementary services at the Prague airport, such as *Czech Airlines Handling, a.s.*, which operates handling services for a number of airlines flying to Prague airport, or *Czech Airlines Technics, a.s.*, which operates repair sheds at the airport. A spe-

[2] Data for 2016. Source: *Česká pošta s. p.* https://www.ceskaposta.cz/o-ceske-poste/profil/zakladni-informace

[3] *Lesy České republiky, s.p.* https://lesycr.cz/o-nas/profil-firmy/

[4] *LOM PRAHA s.p.* http://www.lompraha.cz/o-nas

[5] *Budějovický Budvar, n.p.* http://www.budejovicky-budvar.cz/o-spolecnosti/budejovicky-budvar.html#znamkopravni-spory

[6] *ČEPRO, a.s.* https://www.ceproas.cz/o-nas/produktovodni-sit-a-sklady

[7] *MERO ČR, a.s.* http://www.mero.cz/

[8] *ČEPS, a.s.* https://www.ceps.cz/CZE/O-spolecnosti/Stranky/Default.aspx

[9] *Český Aeroholding, a.s.* http://www.cah.cz/cs/

cific example of a company wholly owned by the state is ***Thermal - F, a.s.*** It operates a large four-star hotel and congress complex in Karlovy Vary, built in the "brutalist" architectural style of the 1970s that is unusual for its 19th-century spa town location, which annually hosts the Karlovy Vary International Film Festival[10].

The state further maintains majority or significant shareholdings in many other companies (e.g. *Výzkumný a zkušební letecký ústav, a.s.*, *PRISKO, a.s.,* or *GALILEO REAL, k.s.*, among others).

KEY COMPANIES WITH GOVERNMENT SHAREHOLDINGS

First of all, through the Ministry of Finance, the state keeps a majority shareholding of 69.78%[11] in the Czech energy giant ***ČEZ, a.s.***[12]. Shares of *ČEZ, a.s.* are publicly listed at the stock exchanges in Prague and Warsaw, and belong to the PX index, a WIG-CEE index. It is the second-biggest company by turnover in the Czech Republic (after car manufacturer *Škoda Auto, a.s.*)[13]. Its turnover in 2016 reached CZK 203,744 million (about EUR 7,546 million). *ČEZ, a.s.* and its subsidiaries (the *ČEZ Group*) are involved in a broad spectrum of the energy business, primarily in electricity generation. It carries business in the Czech Republic and the broader region. In the Czech Republic, it has a power generating portfolio that includes two nuclear plants (Temelín and Dukovany), coal-fired and gas power plants, all of the biggest hydroelectric power plants, several wind and solar power plants, and other renewable sources. It also distributes electricity and other commodities (including gas and heat) to end customers and operates coal extraction businesses.

Its dominant position in the Czech energy business, accompanied with its financial strength and specific know-how in the sector, previously led to business expansion in electricity generation, electricity distribution, and sales into regional markets, including Poland, Romania, Bulgaria, Hungary, Slovakia, and Turkey.

The expansion is pursued either solely by the ČEZ Group or, as in Poland and Turkey, in cooperation with a local partner. The ČEZ Group also uses subsidiaries in the Netherlands and Ireland as holding companies, and for the provision of finances to the operation of the group. It holds an A-rating by Standard & Poor's and a Baa1 rating by Moody's. Since 2007, *ČEZ, a.s.* has maintained a policy to distribute around 50%-60% of the consolidated profit of the group among its shareholders. In 2016, CZK 21,369 million (about EUR 791 million) was distributed among shareholders with a direct infusion of CZK 15 billion (about EUR 550,000 million) into the state budget.

Besides *ČEZ, a.s.*, the state possesses shareholdings in various companies with specific roles in financial support provided to exporters, especially in the case of exports to target destinations which, for various reasons, makes private insurance of other financial instruments hardly accessible, such as *Česká exportní banka, a.s.* (state shareholding of 43.68%) and *Exportní garanční a pojišťovací společnost, a.s.* (state shareholding of 40%). Similarly, specific financial needs for regional development could be assisted by *Českomoravská záruční a rozvojová banka, a.s.*, in which the state holds a shareholding of 32.95%.

A company owning a big congressional center in Prague (*Kongresové centrum Praha, a.s.*), again with communist-era architecture, as in case of the previously mentioned Thermal hotel, is also owned by the state. In this case, the shareholding is 54.35%.

The state keeps also approximately 1/3 of shares (34.22%) in the company manufacturing modern steel radiators and heating systems, *KORADO, a.s.* In this case, the shareholding is not a result of a strategic decision of the state, but is a direct consequence of the financial reconstruction of the company in the late 1990s, in which the state Czech Consolidation Agency that adopted a problematic loan of *KORADO, a.s.* from a Czech bank played its role. In the late 1990s, the Czech economy faced a serious crisis with its main banks. As a result of the reconstruction of the banking sector, the state and the Czech Consolidation Agency assumed the bad debt of several banks together with its security, including shareholdings in some of the privatized companies.

> AN INTERESTING AND POLITICALLY SENSITIVE AREA IN WHICH SOEs USUALLY OPERATE IS RAILWAY TRANSPORTATION

A similar story involving the Czech Consolidation Agency could be found behind one of the most curious present shareholding of the Czech state. It is a shareholding of 96.5% in *VIPAP VIDEM KRŠKO d.d.*, from Slovenia, one of the biggest paper plants in South-Eastern Europe. In both cases, the state is looking for a way to privatize its shareholdings in *KORADO, a.s.* and in *VIPAP VIDEM KRŠKO d.d.*, but all attempts have ended in vain.

CZECH RAILWAY AND ITS PRIVATE COMPETITORS

An interesting and politically sensitive area in which SOEs usually operate is railway transportation. The majority of railway tracks in the Czech Republic is owned by the state through *Správa železniční dopravní cesty* (SŽDC). The railway lines network is one of the densest globally, given the industrial tradition of the country, but lacks modern high-speed tracks. Its total length is 9,463 kilometers. In recent years SŽDC also gained control over most of the important train stations in the country, previously owned by railway operator *České dráhy, a.s.*

SŽDC offers infrastructure to railway operators in accordance with EU legislation. The major railway operator in the country is the wholly state-owned company *České dráhy, a.s.* In 2016, *České dráhy, a.s* and its subsidiaries (*ČD Cargo, a.s.* in particular) had 23,664 employees and transported 171.5 million passengers and 65.5 million tons of cargo[14]. According to the statistics of SŽDC, the group covers over 90% of passenger transport in the Czech Republic,

[10] *Thermal - F, a.s.* http://www.thermal.cz/cs/o-hotelu/

[11] The shareholdings are mentioned according to actual data provided by ministries responsible for the state rights as a shareholder for the specific company in question.

[12] *ČEZ, a.s.* https://www.cez.cz/cs/o-spolecnosti/cez/profil-spolecnosti.html

[13] Data for 2016. Source: Czechtop100. http://www.czechtop100.cz/menu/aktualne/vysledky-100-nejvyznamnejsich-firem-cr-2016.html

[14] *České dráhy, a.s.*, "Výroční zpráva skupiny, 2016". http://www.ceskedrahy.cz/assets/pro-investory/financni-zpravy/vyrocni-zpravy/vyrocni-zprava.pdf

> WHILE ČESKÉ DRÁHY, A.S. CAN PROFIT FROM ITS BROAD COVERAGE OF TRAIN LINES WITH SUPPORT BY STATE OR REGIONAL SUBSIDIES AND UTILIZE ECONOMY OF SCALE IN TRAIN TRANSPORTATION, THE PRIVATE COMPANIES AS NEWCOMERS CANNOT RELY ON SUCH AN ECONOMY OF SCALE AND MUST COMPETE WITH ADDITIONAL SERVICES AND OTHER FORMS OF CONNECTED TRANSPORTATION

measured both as train kilometers and train tons[15], and over 60% in cargo transportation[16].

Several private companies started to operate individual commercial lines (lines that are commercially sustainable from passenger fare and other commercial activities without state subventions for operation), such as the train connection Prague–Ostrava, connecting the capital and north-eastern city of Ostrava, which is the third-biggest city in the country. Those lines are operated by private companies and *České dráhy, a.s.* in parallel, which has led to a significant increase in passenger comfort and related services, and also in price competition that kept fares at a reasonable level.

The two biggest private companies competing with *České dráhy, a.s.* are *RegioJet, a.s.* (about 3% of passenger transport by train kilometers and about 7.5% by train tons) and *LEO Express, a.s.* (about 1.5% of passenger transport by train kilometers and about 1.3% by train tons[17]. The remaining smaller private operators in the Czech Republic (such as *GW Train Regio a.s., ARRIVA vlaky s.r.o.*, or *Die Länderbahn GmbH DLB)* have shares significantly below 1%.

There are several factors that make competition with *České dráhy, a.s.* harder for the newcomers. For instance, *České dráhy, a.s.*, as a traditional national train operator, provides various fare discounts or free rides to tens of thousands of its employees or former employees and their families. In this way, it creates a group of passengers financially motivated to use their services and, if travelling in a bigger group, persuading others to use *České dráhy, a.s.* services. While *České dráhy, a.s.* can profit from its broad coverage of train lines with support by state or regional subsidies and utilize economy of scale in train transportation, the private companies as newcomers cannot rely on such an economy of scale and must compete with additional services and other forms of connected transportation.

[15] *SŽDC*, "Podíl jednotlivých dopravců na výkonech v osobní dopravě". http://www.szdc.cz/provozovani-drahy/dopravci/podil-vykonu.pdf

[16] Ibid.

[17] Ibid.

RAILWAY PRIVATIZATION IN REVERSE: NEW TREND OR BLIND IDEOLOGY? COMPARISON WITH THE U.K.

The issue of railway privatization is not a hot political topic only in the Czech Republic. The Labour Party manifesto for the 2017 general election in the United Kingdom calls for bringing "private rail companies back into public ownership as their franchises expire" and, as a result, promises "lower prices, more accountability, and a more sustainable economy"[18]. Instead of a hybrid system in which privatization will go step by step on tracks that may be commercially sustainable without any public money, the United Kingdom started in the 1990s with the outright opening of all lines to private operators.

A further difference between the Czech Republic and the United Kingdom is that the latter did not preserve any significant state-owned national operator. Without any counterexample, Labour could claim that a state-owned company would be more effective. However, the issue is much more complicated.

The private companies operating rail routes in the United Kingdom are quite often not fully private, but represent various joint ventures with participation of state-owned or, at least, majority state-owned railway companies from Germany (*Arriva* as a subsidiary of *Deutsche Bahn*), the Netherlands (*Abellio* as a subsidiary of *Nederlandse Spoorwegen*), and France (*Keolis* as a subsidiary of *SNCF*). In that light, the Czech system of hybrid cohabitation of one national railway operator and several gradually growing genuine private companies appears to be a more sustainable alternative. It may not be threatened to be splashed by a sudden change of the mood of political leadership as it would be in the United Kingdom if the current Labour manifesto is ever used in practice.

> THE CZECH SYSTEM OF HYBRID COHABITATION OF ONE NATIONAL RAILWAY OPERATOR AND SEVERAL GRADUALLY GROWING GENUINE PRIVATE COMPANIES APPEARS TO BE A MORE SUSTAINABLE ALTERNATIVE

If the opening of new railway lines to private operators is gradual, and does not fall asleep somewhere on its way, it can pro-

[18] The Labour party manifesto 2017, "For the many, not the few", http://www.labour.org.uk/page/-/Images/manifesto-2017/labour-manifesto-2017.pdf, p. 19.

vide space for the development of genuine private operators (not only branches of foreign SOEs) that could remain.

STATE, REGIONAL, OR MUNICIPAL?

The state remains an important player in the operation of strategic infrastructure (transportation, energy) and several related business activities. Two main forms, state enterprises or shareholdings in private companies, are available. The first form is used for the operation of natural resources (river basins, forests) owned by the state and some other business operation. The second form has a much broader use.

The state as such is not the only public body that pursues commercial activity. State involvement in the economy is at various levels supplemented by commercial activities pursued by entities owned (fully or partially) by other public bodies, i.e., Czech regions (*kraj*) and municipalities. The state and its SOEs in various legal forms, as described above, are present in sectors and areas necessary for the whole country. Other public entities are involved in business activities that are relevant locally or for a specific region. For instance, the international airport in Prague-Ruzyně has, with its annual share of more than 90% of total air traffic in the Czech Republic (by number of passengers), relevance for the incoming and outgoing tourism of the whole country and is owned by the state. In contrast to this, the other international airports in the country, such as Brno-Tuřany or Ostrava-Mošnov, have only regional importance and are owned by the corresponding regions.

The business enterprises owned at a sub-state level of public authority are usually ordinary commercial corporations founded by a region or municipality with the aim to pursue a specific activity that corresponds to the self-governing tasks of its founder. The category of state enterprises is not available at this local or regional level.

An example of one of the biggest publicly-owned companies in the hands of a municipality is *Dopravní podnik hl. m. Prahy, a.s.*, which is a transportation company wholly owned by the capital city Prague. It has about 11,000 employees and operates three lines of the underground, 33 tram lines, and 142 bus lines in the capital[19]. Most of the bigger towns in the Czech Republic have their own transportation companies responsible for operating mass transportation within its territory and most of the related infrastructure. A specific situation remains in the railway sector, where the track and train stations of regional or local importance are owned by state through *SŽDC*.

[19] *Dopravní podnik hl. m. Prahy, a.s.* http://www.dpp.cz/dpp-v-datech/


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Privatization in Bulgaria: State Ownership Is Dead, Long Live State Ownership!

*
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In recent years, privatization in Bulgaria has gradually lost momentum after large-scale investment was finalized in 2003-2004. Judged by the amount of revenue, it has reached a point of a virtual stall in 2015–2016 as privatization proceeds fell to just BGN 3–4 million (EUR 1.5-2 million)[1] annually. The view that dominates the executive power more and more is that no more assets in the Bulgarian economy can be privatized. In other words, everything that had been "privatizable" was already privatized in the transition period and privatization should be deemed finished. Ironically, one of the loudest voices of this political line is the current minister of economy, Emil Karanikolov, who managed the national privatization agency between May 2011 and May 2017 until he became minister.

> HOWEVER, PLENTY OF STATE- (SOEs) AND MUNICIPAL-OWNED ENTERPRISES (MOEs) PERFORM FUNCTIONS AND ACTIVITIES THAT THE STATE AND LOCAL AUTHORITIES SHOULD NOT ENGAGE IN AT ALL, – AT LEAST NOT IN A MARKET ECONOMY

However, plenty of state- (SOEs) and municipal-owned enterprises (MOEs) perform functions and activities that the state and local authorities should not engage in at all – at least not in a market economy. Among existing state and municipal enterprises, one can find companies for dairy production, cargo transportation, garbage collection, music and video recording, textile production, and the like. Apart from these, the state keeps its interest in other sectors (electricity, railway transport, and health care) where its dominance prevents their liberalization, distorts competition, and leads to huge subsidies from the state budget to these companies each and every year.

Public choice makes it clear why the privatization freeze has happened. State enterprises are a convenient tool for the pursuit of political goals: They are used for populism or mere profiteering by politicians. Their employees and clients are a large voter base, easily manipulated before elections. Their assets and market share, on the other hand, are a "tasty treat" for politicians, their relatives, and donors. Some of those companies also benefit from monopoly or "fast-track" access to certain public procurement orders. For instance, the Ministry of Interior has its own textile company (Intendantsko Obsluzhvane)

[1] The Bulgarian lev was pegged to the Deutsche mark in mid-1997 with the introduction of a currency board arrangement. With Germany's adoption of the euro, the anchor currency for the lev became the euro at a rate of 1.99583 leva per euro; the fixed exchange rate has not been re-valued to date.

> BULGARIAN CITIZENS WILL KEEP PAYING THE BILLS FOR SOEs THROUGH BUDGET SUBSIDIES TO UNPROFITABLE COMPANIES, HIGH PRICES, AND LOW-QUALITY GOODS AND SERVICES

Table 1: Fiscal Price of Banking Crises in CEE, % of GDP

Country	Budget expenditure due to banking crises, 1991–1998
Georgia	0.1
Estonia	1.9
Latvia	2.7
Lithuania	3.1
Poland	7.4
Kyrgyzstan	10.6
Hungary	12.9
Kazakhstan	18.4
Czech Republic	25.4
Macedonia	30.3
Bulgaria	41.6

Source: *Anatomy of Transition* by IME, citing World Bank's WP 2484

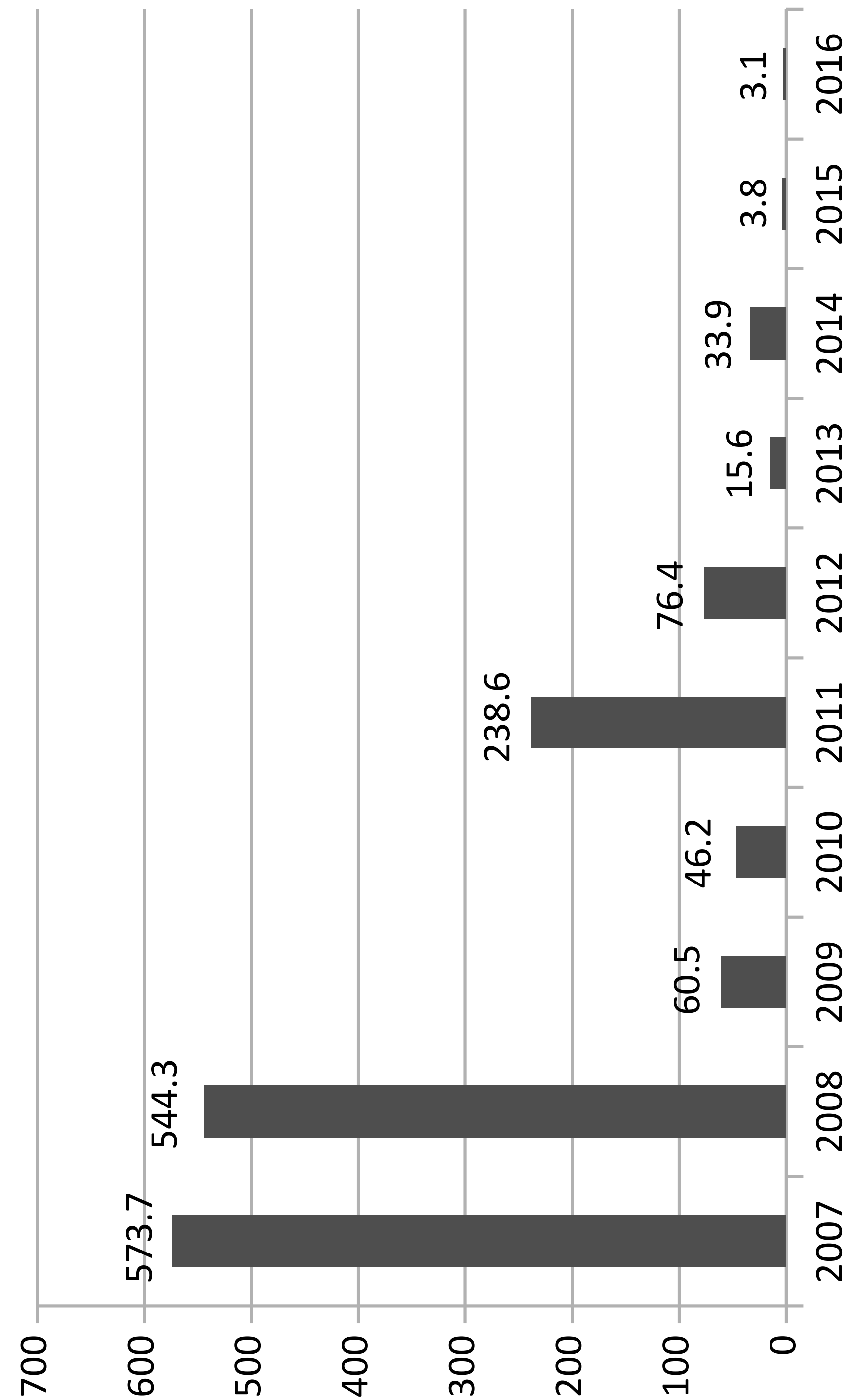
which sews police uniforms – even if the Bulgarian economy is flooded with private textile companies.

Prospects for a privatization revival are meager, considering the increasingly strong capture of Bulgarian institutions by private interests. In the meantime, Bulgarian citizens will keep paying the bills for SOEs through budget subsidies to unprofitable companies, high prices, and low-quality goods and services.

PRIVATIZATION IN BULGARIA: A BRIEF HISTORY

Similar to other CEE economies, privatization in Bulgaria did not start with the 1989–1990 transition period. The same

Figure 1: Proceeds from privatization (BGN million, net)



Source: Ministry of Finance

applied to other market reforms, too, as the dominant view among policymakers at that time was that Bulgaria should undertake gradual changes to minimize social suffering. Bulgaria formed part of the "gradualists" among former socialist countries, in contrast to "shock reformers" who embarked radical reforms in the early 1990s. With hindsight, this choice cost Bulgarians dearly in terms of standards of living, economic development, and catching up to developed economies.

By 1997, about 70% of Bulgaria's economic assets were still state-owned[2]. In 1996–1997, the Bulgarian economy was ravaged by a full-blown currency, banking, and economic crisis which led to rapid devaluation, hyperinflation, and 17 bank failures that accounted for about 1/3 of the sector (in terms of deposits). Bulgaria's banking crisis was the most expensive in the entire CEE in GDP terms [See Table 1].

Table 2: Sectors in which SOEs operate

Sectors	2016
Telecoms	1
Mining and quarrying	3
Real estate	6
Finance	7
Manufacturing	16
Electricity and gas	17
Transport	17
Other utilities (e.g. water and sewerage)	31
Other activities (e.g. health care, engineering, R&D, sports, culture)	177
Total	275

Source: Ministry of Finance, IME's estimates

[2] See, for instance, IMF's "25 Years of Transition. Post-Communist Europe and the IMF", Regional Economic Issues, Special Report, Oct. 2014.

The crisis was put an end to in mid-1997 when a caretaker government approved a stabilization program, underpinned with financial support from the International Monetary Fund (IMF). The cornerstone of the stabilization plan was a currency board arrangement that swiftly restored currency stability and subdued inflation.

Table 3: List of Bulgarian companies banned for privatization (categorized by their administrative designation)

Ministry	Number of SOEs that it manages
Ministry of Exterior	1
Ministry of Finance	2
Ministry of Interior	2
Ministry of Energy	2
Ministry of Youth and Sports	3
Ministry of Education and Science	4
Ministry of Culture	5
Ministry of Defense	7
Ministry of Agriculture and Food	14
Ministry of Transport	15
Ministry of Economy	16
Ministry of Regional Development and Public Works	39
Ministry of Health Care	70
TOTAL	**180**

Source: Law on Privatization and Post-Privatization Control

Another important part of the recovery plan was the acceleration of the privatization process. The period of 1997–1999 marked the privatization of a number of large-scale enterprises, such as the Bulgarian flag carrier (Bulgaria Air), the Neftochim oil refinery, the Kremikovtsi smelter, and several cement plants, among others. The privatization of state-owned banks also gained momentum in the 1997–1999 period. The privatization of seven state banks started in the summer of 1997 with the sale of United Bulgarian Bank to a consortium of EBRD, US Oppenheimer & Co., and the Bulgarian Bulbank. Between 1998 and 2003, all remaining state-owned banks on the list for privatization (Postbank, Biochim Bank, Hebrosbank, Bulbank, Expressbank, and DSK Bank) were sold, with the former state savings bank, DSK Bank, being the last to change hands. With its sale, the process of bank privatization was declared officially closed.

STATUS QUO

Currently, the state still holds about 11% of the Bulgarian economy in terms of the state's share in the capital of enterprises registered in the country, according to the 2015 data from the National Statistical Institute. Most of this, 10.71%, stands for the state's share in companies which are majority-owned by the state; the remaining 0.27% share is the state's interest in private companies. The latter was largely a result of the practice to retain a so-called "golden share" (with voting rights) in privatized companies to keep a final say on future large-scale changes in the company.

> ”
> WHY SHOULD THE STATE PRODUCE DAIRY PRODUCTS, RECORD AUDIO AND VIDEO, TEACH FOREIGN LANGUAGES, PUBLISH BOOKS, OFFER PRIVATE SECURITY, OR SELL INSURANCE IF THERE ARE PLENTY OF PRIVATE COMPANIES THAT DO IT?

A glance at the dynamics of privatization proceeds to the state budget clearly shows the privatization slow-down in recent years. This process was more or less brought to a halt in 2015 and 2016 when proceeds fell to an all-time low of BGN 3.1 million (EUR 1.6 million). As a result, the state's share in the capital of local companies has remained roughly unchanged at 11% in the 2013-2015 period [See Figure 1].

The view that hardly anything remains for privatization is debatable. The most recent data of the Ministry of Finance (MF) shows that the state has majority ownership in 275 companies. Even if law requires financial and narrative reports of those companies to be published on the site of the MF each quarter, some of them are missing or uploaded with big delays. That, together with the fact that there is no unified format for the information, makes any attempt at summarizing this data doomed to failure or gross imprecision.

The situation with municipal-owned enterprises is even more opaque. Hardly anyone can say (with any certainty) how many of them operate in the economy. No regular (or even irregular) financial data exists for those companies. MOEs are diverse in their activities – waste collection, engineering, real estate management, waste recycling, maintenance of green areas, radio and TV broadcasts, sports facility maintenance, baby food production, and others. Private companies exist in those sectors in large numbers.

As regards state-owned companies, the MF list shows that almost 1/3 of them are hospitals and medical care units, and about 1/10 are local water and sewerage companies. In addition, there are several energy companies (mostly for generation and transmission), seaports, riverports, and airports, regional forest management companies, scientific and research institutes, and a number of industrial/economic zones [See Table 2].

Notably, an annex to the Bulgarian privatization law (in effect since 2004) contains a list of companies that are banned for privatization [See Table 3]. The list[3] has undergone changes since its conception, but officially, it contains companies presumed to be "of strategic interest" to the state, or which are part of Bulgaria's security and defense system [See Table 3].

The list of companies banned for privatization currently contains 180 companies majority-owned by the state. This, compared to a total of 275 state companies, means that some 2/3 of all state companies are not earmarked for privatization. The list contains 76 hospitals and health care units, 31 water and sewerage companies, five airports and five sea/river ports, arms producers, railway and energy companies, forest management companies, research centers, irrigation companies, holiday resort, canteen, foreign language teaching center, publishing house, textile company, real estate company, a dairy producer, perfume laboratory, events hall, sports bases and halls, a tech park, audio&video maker, music recorder, film maker, and a private security company (the latter also trades in weapons and acts as an insurance broker).

Even if one can think of arguments in support of the state's strategic interest in some of the above-mentioned companies, there is hardly any rationale why the state should keep its shareholding in others. For instance, why should the state produce dairy products, record audio and video, teach foreign languages, publish books, offer private security, or sell insurance if there are plenty of private companies that do it? The presence of the state distorts competition and the state companies keep a chunk of the market exclusively for themselves. Also, the implicit guarantee from the state makes them function under softer budget constraints, which in turn allows them to offer below-market prices.

[3] See Annex 1 of Law on Privatization and Post-Privatization Control, http://lex.bg/laws/ldoc/2135439873

The situation with arms producers is even more serious. Information on the export of arms producers is not public, which periodically fuels scandals about illegal export of weapons to conflict-ridden countries, authoritarian regimes, and ISIL. One expects that arms production and trade is a lucrative business that no government wishes to let go.

Apart from the list of companies banned from privatization, there are also 95 SOEs, for which privatization is not a threat even if they are not formally a part of this list[4]. That category includes mines, construction and engineering companies, foreign trade companies, a bank, an IT company, and a lottery, among others. As is the case with other SOEs, many private companies operate in those sectors, against which the SOEs often gain an unfair advantage in public procurement. That does not include the related risks of corruption, misuse, and waste of public funds that those enterprises are exposed to.

HOW SOEs SERVICE THE GOVERNMENT: BEST PRACTICES IN A NUTSHELL

SOEs have traditionally been used by politicians to service their private or wider partisan interests. The many uses of SOEs, based on Bulgaria's experience, can be summarized as follows:

[4] See: Annex 1 of Law on Privatization and Post-Privatization Control, http://lex.bg/laws/ldoc/2135439873 (in Bulgarian).

> NO PUBLIC STATISTICS ON THE DIVIDENDS PAID BY THE SCC EXIST, SO ONE CAN ONLY GUESS HOW MUCH PROCEEDS HAVE BYPASSED THE SILVER FUND

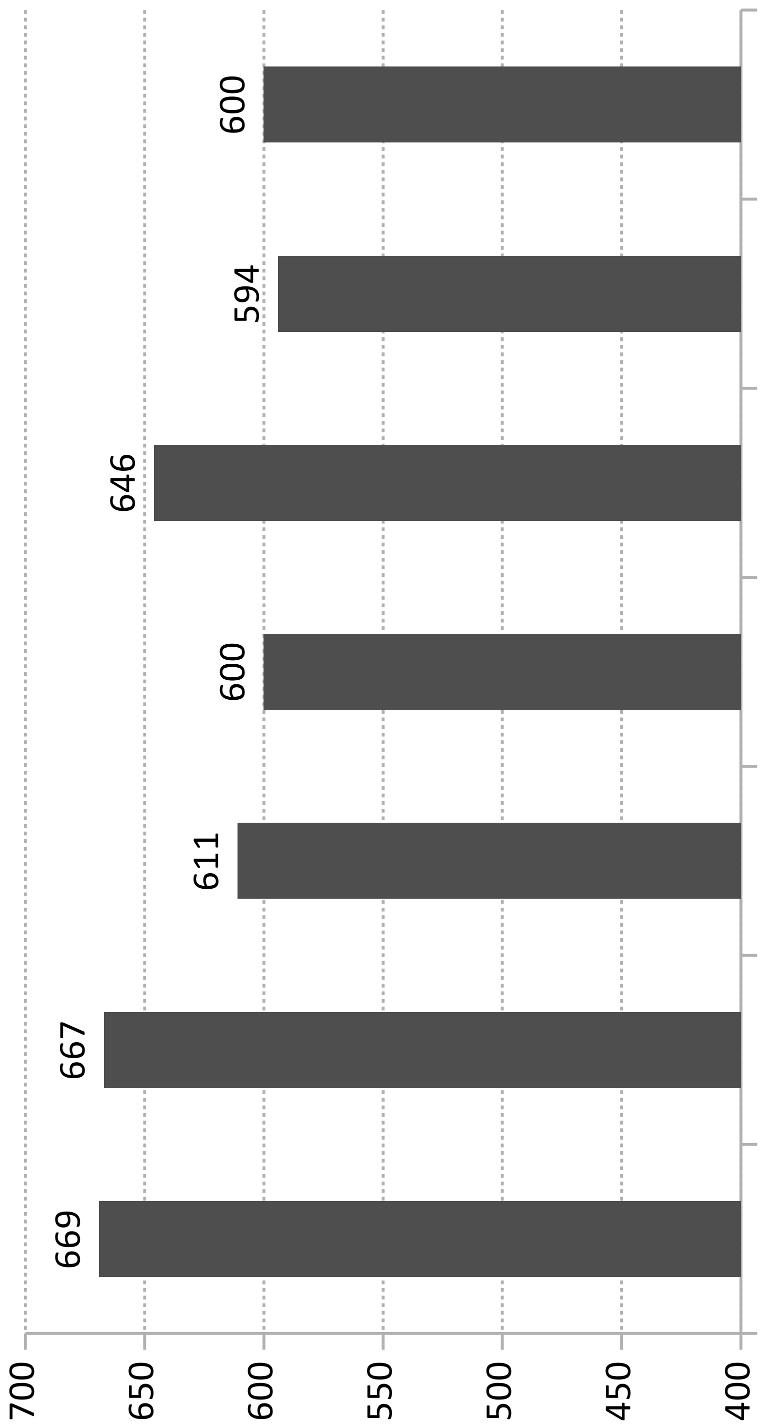


Figure 2: Current subsidies and capital transfers from the state budget to SOEs (BGN million)

Source: IME's calculations, based on responses to request for public information

> FINANCIALLY UNSUSTAINABLE COMPANIES ARE KEPT AFLOAT FOR YEARS DESPITE HUGE LOSSES AND MOUNTING DEBT

1) Political appointments to SOE management bodies

This is usually used for influence trading and payback of favors. Sitting on the board of an SOE pays well in monetary terms. Moreover, appointments can serve as a stepping stone for future interactions between the appointer and the appointee with the aim of mutual profiteering. SOE board appointments are made in a non-transparent and non-competitive way, and board mandates usually follow government mandates.

2) Use of SOEs and their assets for private business interests (i.e. draining of SOEs)

A recent example was the appointment of a board member to the board of dairy producer LB Bulgaricum, who was said to have close ties to a local crony businessman, Delyan Peevski, with an interest in the dairy market[5]. Thus, the state-owned company could service the interest of Peevski, who reportedly used its production facilities and technologies to produce dairy products under his own brands.

3) Use of SOEs for populism and boosting party ratings

A good illustration of this "practice" was energy price regulation in 2013–2014. With the help of an energy sector regulator (independent in name only), end-prices for individual consumers were sharply reduced in three consecutive actions. Thus, the National Electricity Company was used as a "buffer" for underpricing electricity bills for households, a populist motivation. As a result, the NEC experienced losses and rising debt.

> THE PASSENGER RAILWAY COMPANY (BDZ–PASSENGER TRANSPORT) AND THE POST COMPANY (BULGARIAN POSTS) HAVE BEEN TRADITIONALLY KEPT AFLOAT WITH REGULAR BUDGET SUBSIDIES

[5] See:http://www.capital.bg/biznes/kompanii/2015/04/03/2505954_zakvaskata_na_peevski/ or http://www.capital.bg/politika_i_ikonomika/bulgaria/2016/11/23/2869859_lukarski_udarno_smenia_direktorski_bordove/? (both in Bulgarian).

> THE BIGGEST "BLACK HOLES" FOR BUDGET TRANSFERS ARE THE THREE RAILWAY COMPANIES: NATIONAL COMPANY RAILWAY INFRASTRUCTURE, THE INFRASTRUCTURE OPERATOR; BDZ–RAILWAY TRANSPORT, THE PASSENGER TRANSPORT COMPANY; AND BDZ HOLDING, THE RAILWAY HOLDING COMPANY

Two other companies traditionally exploited on populist grounds are the state passenger railway company, BDZ–Passenger Transport, and Bulgarian Posts. The problem with this use of SOEs is their direct and indirect cost on the state budget, realized as subsidies and capital transfers from the annual budget. The former are used to boost the revenue side of the company and reduce its losses, while the latter are used to cover losses or repay debts.

In addition, state guarantees on the loans to such companies are another common practice, which in turn result in higher state-guaranteed debts and are a source of contingent liabilities for the state. Notably, it has already happened in the past that BDZ–Passenger Transport was not able to service its state-guaranteed debts and the state guarantee was triggered. The risk of that contingency for the budget is quite real.

4) Use of SOEs to channel privatization proceeds to the budget revenue side with the help of "creative accounting"

This appears to be an original tool invented recently by the Bulgarian Ministry of Finance. The purpose of this "creative accounting" was to side-step the law on the establishment of a so-called "silver fund".

According to this law, all privatization proceeds should be directed to this fund, so that it can support the pay-as-you-go pension system sometime in the future. Yet, in 2009, the then-government bypassed the silver fund law by establishing a new state-owned holding company, the State Consolidation Company. The purpose of its establishment was to find a legal way to channel privatization proceeds to the budget revenue side, rather than classify them below the budget bottom line as budget deficit financing. In the latter case, those proceeds should be transferred to the silver fund.

After SCC was established, state stakes at SOEs earmarked for privatization have contributed to the capital of SCC. As a result, as soon as such companies are privatized, the proceeds from their sale are classified as revenue of SCC. Then, after year-end, 80% of the profit of SCC (in fact, privatization proceeds) is being paid as dividend to the state budget. That is classified as non-tax revenue to the budget and boosts the revenue side, serving as a hidden fiscal expansion tool. No public statistics on the dividends paid by the SCC exist, so one can only guess how much proceeds have bypassed the silver fund. As a result, the government has found one more budget revenue source, while the resulting budget deficit is financed out of the fiscal reserve or by issuing new state debts.

NEW SOEs KEEP EMERGING

Given all the opportunities for the government to exploit an SOE, it is no surprise that the emergence of new SOEs has been a trend. It has been done either by establishing a new SOE or renationalizing formerly privatized companies.

In 2016, for instance, the formerly privatized Avionams (a military aircraft maintenance and repair works plant) was acquired by the State Consolidation Company. The deal became possible after Avionams was declared insolvent and its assets put up for sale. The renationalization was justified by the government due to the importance of the company for Bulgaria's military aircraft.

As regards the establishment of new state-owned companies, there have been several cases. In 2008, the then-government established Bulgarian Energy Holding, a holding company for all its shareholdings in the energy sector. The company aimed to attract financing for ailing state energy companies in local and foreign markets. In other words, it is a tool for cross subsidies in the state energy sector. As its balance sheet combines profitable and unprofitable/heavily indebted companies, it can attract loans and place bonds on much better terms than some of its subsidiaries. The financing can then be lent to daughter companies that have no access to market financing.

This has already happened twice as BEH placed two bond issues between 2013 and 2016 for a total value of EUR 1,050 million, and then re-lent the money raised through two loans to the heavily indebted state-owned National Electricity Company. Thus, energy-sector SOEs in dire financial states – that have no access to capital markets – continue to receive funding through the BEH bypass. As a result, financially unsustainable companies are kept afloat for years despite huge losses and mounting debt. After BEH, the government established the previously mentioned SCC in 2009. A couple of years ago, the state-owned Sofia Tech Park, meant to become a hitech R&D hub, has also started operations. EU funds entirely financed the Tech Park, but so far, it remains almost entirely vacant.

THE PRICE OF SOEs FOR TAXPAYERS

The direct price of SOEs for taxpayers comes in the form of current subsidies and capital transfers from the state budget, annually allocated to SOEs. Occasional repayment of state-guaranteed debts of SOEs when debtor companies fail to pay on time adds to the direct costs for the budget.

As mentioned above, current subsidies are channeled to the revenue side of the SOE, typically in order to compensate the company for its legally imposed social role (e.g. regular postal services in far-off villages or access to railway transport for residents of hard-to-reach settlements and socially disadvantaged groups). The social dimension is embodied in below-market prices of goods and services. The state budget then covers the difference between the discounted price and the market price, taking into account the actual cost for the company to deliver the service to socially vulnerable customers.

The passenger railway company (BDZ–Passenger Transport) and the post company (Bulgarian Posts) have been traditionally kept afloat with regular budget subsidies. Their subsidies remain unchanged (or rise in some years, even if fewer customers use their services) while inefficiency is blatant. For instance, only some 30% of the revenues of BDZ–Passenger Transport are generated from fares; the other 70% comes as a state subsidy.

Capital transfers, in turn, are used to capitalize unprofitable and heavily indebted companies. If the company is chronically unsustainable, this means a long-term "subscription" to state transfers.

The total volume of current subsidies and capital transfers to the state budget, annually, is substantial. Though no unified database for these payments exists, in 2015, IME sent requests for public information to all ministries, asking for information on the annual subsidies and transfers to SOEs under their control. The information obtained from some of the ministries (not all bothered to respond) shows that, for the period between 2007 and 2013, the state budget allocated a total of BGN 4.4 billion (EUR 2.25 billion) to SOEs through subsidies and capital transfers. That sum represents 2.4% of all general government expenditure for the period (BGN 185 billion; EUR 94.6 billion). In comparative terms, that is equal to 25% of all budget expenditure on education for the period and a rough annual burden of BGN 624 million (EUR 319 million) on the state budget [See Figure 2].

Capital transfers account for about 1/3 of the annual state support spent on SOEs. That instead of this that 2/3 of the regular transfer from the state budget to SOEs goes to finance current expenses. Hence, it affects the annual revenue and expenditure of the company, but not its long-term financial health.

Among all, the biggest "black holes" for budget transfers are the three railway companies: National Company Railway Infrastructure, the infrastructure operator; BDZ–Railway Transport, the passenger transport company; and BDZ Holding, the railway holding company. Those SOEs received almost 2/3 of all subsidies and capital transfers from the budget to SOEs over the period.

Recent data on those companies show that the situation has changed little since 2013. Annual budget transfers to the three railway SOEs already approach BGN 500 million (app. EUR 250 million), with the passenger transport company receiving about half of these funds. Those transfers are equal to about 0.5% of GDP and 2%-2.5% of the state budget. The state allocation for the railway companies is more or less equal to the entire funding for the judiciary and exceeds the state subsidy to higher education establishments.

Another illustration of the inefficiency of the state railways is the growing amount of state transfers per transported passenger. The number of passengers has been on a stable downward trend – from 50 million people in 2000 to 24.5 million people in 2014. Thus, the total state support to the company rose from BGN 6 (app. EUR 3.1) per passenger in 2010 to BGN 8.2 (EUR 4.2) in 2014 – more than 30%.

CONCLUSIONS

More than 230 state-owned enterprises exist in Bulgaria. No one knows the exact (or even rough) number of municipal-owned enterprises, but some estimates find about 800. After a political drive for privatization in the late 20th century, the process has gradually slowed in the last decade, reaching a freezing point in 2015–2016. A key reason for the suspension of privatization was better-than-expected budget performance in those years and hefty surpluses toward year-end, which rendered the need of privatization proceeds to finance budget deficits obsolete.

Bulgarian governments have traditionally used SOEs for populism or for private and partisan interests, which, combined with the lack of deficit financing needs, explains why privatization is no longer viewed as a policy option, while new SOEs keep emerging.

In the meantime, SOEs continue to put a heavy weight on the budget as annual budget transfers and contingent liabilities. The drain of public funds, inefficient management, and unsatisfactory services all add up to the price that taxpayers pay for the luxury of having SOEs. ●

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Repolonization and State Patronage: Current Challenges for Poland

*
ADAM
SZŁAPKA

The political earthquake that hit Poland in 2015 with an unprecedented electoral sweep by the Law and Justice party upset contemporary assumptions about Poland. Backed by friendly and financially dependent media[1], Law and Justice (PiS) says its job is to clean up the mess left in Poland by the liberal, corrupt elites who were out of touch with its Catholic and patriotic values.

Since winning the elections, the new Law and Justice government conducted a broad spectrum of controversial "reforms" carried out during its first months.

1. Since November 2015, the Polish government has undertaken significant legal reforms – concerning in particular the Constitutional Tribunal, which has drawn the attention of several regional bodies and the European Commission. The reforms have seriously undermined the Constitutional Tribunal's ability to effectively carry out its mandate, and have created legal uncertainty and an environment where human rights are structurally at risk[2].

2. Apart from infringing upon the independence of the Constitutional Tribunal, the government has embarked on a trajectory of interference with the independence of the judiciary in general[3].

> "IN 2015 AND 2016, WARSAW AND OTHER CITIES EXPERIENCED LARGE-SCALE DEMONSTRATIONS WHEN HUNDREDS OF THOUSANDS OF PEOPLE PROTESTED AGAINST THE GOVERNMENT AND ITS POLICIES

3. What is more, the government adopted an amendment of the Law on Assemblies that introduces a category of "cyclical demonstrations" organized by the same entity in the same location several times a year. Under this law, assemblies organized by the state or the church would have priority over other assemblies. The proposal raised serious concerns over a possible breach of the freedom of assembly under Article 11 of the European Convention on Human Rights[4].

4. In 2016, NGOs have become the target of a massive campaign by public media and pro-government journalists in particular.

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[1] E.g. nationalist and conservative press (*Gazeta Polska, Gazeta Polska Codziennie, wSieci, Do Rzeczy, Nasz Dziennik*), tv stations (TV Republika TV Trwam) or catholic radio (Radio Maryja), as well as public broadcasters (TVP and Polish Radio) are completely subordinated to the government.

[2] http://4liberty.eu/review-4-the-winner-takes-it-all-kaczynski-orban-and-ponta-versus-constitutional-courts/

[3] Law on Prosecution of January 28,2016 (Ustawa z dnia 28 stycznia 2016 r. Prawo o prokuraturze) Journal of Laws 2016 item 177. https://oko.press/the-end-of-independent-judiciary-in-poland-pis-government-brakes-the-constitution-and-assumes-control-over-all-courts/

[4] http://www.hfhr.pl/wp-content/uploads/2016/11/HFPC_opinia_29112016.pdf

The government has imposed certain limiting administrative decisions ranging from funding cuts to administrative controls on human rights organizations[5].

5. The media law passed in December 2015 led to a dismissal of a number of directors and supervisory board members of public TV and radio stations. For the first time since the fall of communism, the government in Poland could soon have almost complete control over the public media.

6. Another new law allows Law and Justice to take control of the civil service. More than 1,600 civil service directors, who are apolitical, can be sacked and replaced without the need to hold open competitions.

Polish society did not accept all the changes. In 2015 and 2016, Warsaw and other cities experienced large-scale demonstrations when hundreds of thousands of people protested against the government and its policies. Hundreds of thousands of people took part in the October 3, 2016, women's strike and Black Protest (#CzarnyProtest) against the proposed near-complete ban on abortions.

In recent months, a number of issues have put the government on the defensive. One has harmed its image particularly hard – cronyism and appointments to state-owned companies (SOEs).

REPOLONIZATION[6] OF POLAND

In finance and development, Law and Justice has also set a controversial goal of boosting state control over the economy.

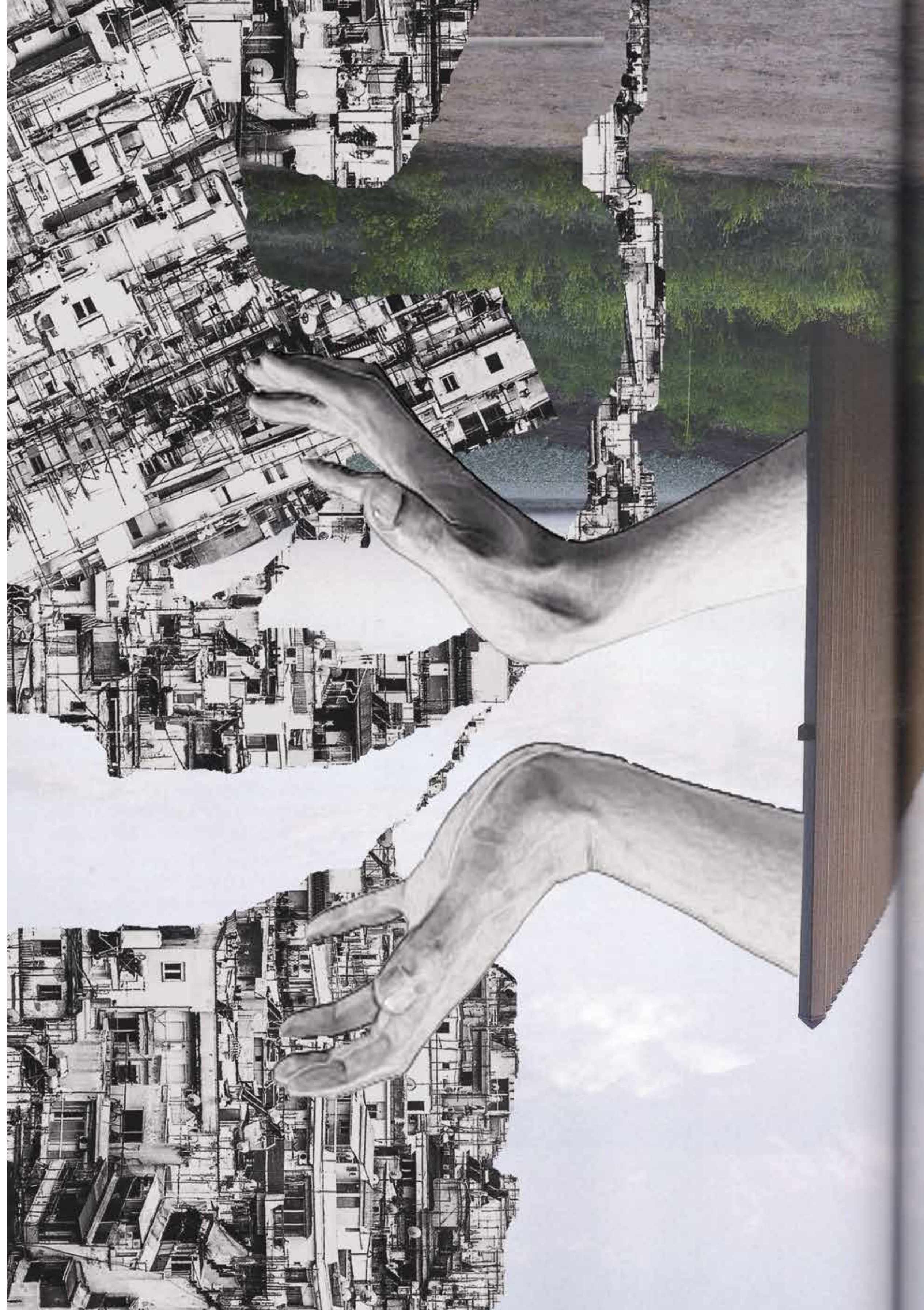
[5] http://www.politico.eu/article/poland-democracy-failing-pis-law-and-justice-media-rule-of-law/

[6] Repolonization means here going back to the "old times" when economy, industry, etc. were in the hands of Polish capital instead of Western capital. It is, however, difficult to say what "old times" PiS has in mind – the communist era of state monopolies or the so-called Second Republic (1918-1945).

> IN ORDER TO "REPOLONIZE" THE ECONOMY, LAW AND JUSTICE WANTS TO MOBILIZE NATIONAL CAPITAL TO INCREASE DIRECT INVESTMENT BY POLISH COMPANIES IN POLAND AND ABROAD

One of the main obstacles for Poland's development – based on the government's Plan for Responsible Development announced by Deputy Prime Minister Mateusz Morawiecki[7] – is a lack of balance between foreign and domestic capital. Morawiecki proposed that some of the PLN 1 trillion (EUR 229 billion) that is about to be mobilized to boost Polish investment come from SOEs.

[7] The objectives of the Morawiecki's Plan are as follows: "an increase in investments to over 25% of the GDP", "an increase in the share of R&D expenditure to 2% of the GDP", and "an increase in the number of medium-sized and large enterprises to over 22,000". According to the plan, the government is willing to spend money immediately on certain investments and branches which are not chosen by consumers and producers but by the state itself. By 2020, PLN 530 billion (EUR 122 billion) from the state budget will be spent as an implementation of the plan (apart from the EU funds and the funds of the state agencies such as the National Health Fund). http://4liberty.eu/morawieckis-plan-as-a-symbol-of-polish-state-interventionism/



GOVERNMENT'S REPOLONIZATION DREAM DOES NOT END WITH FINANCIAL COMPANIES. THERE ARE MANY MORE EXAMPLES, INCLUDING A WORRISOME PLAN OF A CHANGE IN THE MEDIA SECTOR

The government highlights the concept of "repolonization" and need of building "world-class champions". In order to "repolonize" the economy, Law and Justice wants to mobilize national capital to increase direct investment by Polish companies in Poland and abroad.

In 2016, a practical example of this line of thought could be observed in the banking sector, where PZU (Powszechny Zakład Ubezpieczeń, *Polish Insurance Company*), Central Europe's top insurer, took over Alior Bank[8]. "It's our first step in consolidating the Polish banking sector by PZU", Chief Executive Andrzej Klesyk said. PZU was in talks on two more buys as part of a plan to build a top-five banking group[9]. In June 2017, PZU with the Polish Development Fund completed the acquisition of a 32.8% share in Bank Pekao SA for PLN 10.6 billion. It was one of the biggest deals in the European banking industry in recent years[10].

But the government's repolonization dream does not end with financial companies. There are many more examples[11], including a worrisome plan of a change in the media sector – a law that would limit the share of foreign capital in media businesses[12]. It is important to mention here that SOEs are already used by the government to shape the agenda of private media by advertising with public money[13]. Government agencies have ended their subscriptions to the media close to the opposition while state-owned companies have cancelled advertising contracts with them[14]. *Gazeta Wyborcza*, the country's most widely read daily newspaper and a fierce critic of the party, had a 21% decline in revenue from 2015 to 2016, which was partially attributable to reductions in state and SOE advertising. On the other hand, conservative and Catholic media that were marginal on the market have noted a high increase in public advertising[15].

[8] One of the goals of the government was to get Poland's level of share of foreign-owned assets in the banking sector below 50% very quickly. It is 60% today, compared with 12% in Germany, 15% in the UK, and 6% in France.

[9] http://www.reuters.com/article/alior-ma-pzu-idUSL5N0YL03X20150530

[10] Law and Justice's politicians have many dangerous ideas how to use banks to win public support. For example, President Andrzej Duda proposed in his campaign to force banks to convert foreign-currency mortgages back into Polish zloty at historic exchange rates, leaving them with billions of euros in costs. That brought warnings from rating agencies, Poland's banking regulator, and the National Bank of Poland that this could cause a banking crisis. Luckily, Andrzej Duda backed off, when he proposed leaving it to banks to find a "voluntary" solution, encouraged by regulatory pressures.

[11] On the other side Poland has left some foreign-dominated sectors untouched, including the auto industry, which draws hefty foreign investments.

[12] Media landscape in Poland is relatively diversified and competitive, without the oligarchic ownership that made Hungary so vulnerable to state-led capture. But several top Law and Justice MPs announced a media reform coming up in Autumn 2017, which will limit concentration of media ownership in foreign hands.

[13] Poland's performance in the World Freedom Press ranking is dramatic. In 2006, two years after its accession to the EU, Poland ranked 60th in the World Press Freedom Index. It kept climbing up the index until 2015 when it came in 18th – the country's best result so far. Nevertheless, it landed 47th in 2016, and this year it left the top 50, occupying a position similar to the position it had in 2005.

STATE-OWNED ENTERPRISES ARE AN IMPORTANT PART OF POLISH LANDSCAPE

PARTY LOYALISTS WITH LITTLE OR NO EXPERIENCE HAVE ALWAYS BEEN PARACHUTED IN TO REPLACE LONG-SERVING CEOs IN SOME ENTERPRISES

PERSONALIZATION OF PUBLIC GOVERNANCE

State-owned enterprises are an important part of Polish landscape. However, many of them are leftovers from a centrally planned economy. The Polish government owns 326 companies that employ almost 160,000 people. The enterprises are worth more than EUR 50 billion, 17 of them are listed on the Warsaw Stock Exchange, and many are the biggest companies in their sectors. They include banks, insurance, and mining companies.

Using SOEs and agencies as a source of patronage is a problem that all governing parties in post-communist Poland have encountered. Party loyalists with little or no experience have always been parachuted in to replace long-serving CEOs in some enterprises. Regardless whether it is Law and Justice or the Civic Platform, Polish People's Party, or the socialists, all perceive SOEs as a bottomless purse to use.

But Law and Justice was supposed to be different. Jarosław Kaczyński, the party leader, is known as an author of the so-called "TKM" expression that is used by Poles with reference to a "winner mentality", which typically prevails after an election victory. The infamous "TKM" stands for "*teraz, k***, my*" ("*This is our f*** time now*"). He used the term publicly in a 1997 interview for *Gazeta Wyborcza*[16] while explaining why he did not run in the Sejm elections on the AWS[17] ticket, although he

[14] http://www.tol.org/client/article/27054-rise-and-fall.html

[15] Conservative weekly magazine *wSieci* noted a 1000% increase and *Do Rzeczy* a 700% increase. http://wyborcza.pl/7,155287,22046074,panstwowe-spolki-nieracjonalnie-wydaja-pieniadze-na-reklame.html

[16] Karnowski, M.,ichał; Zaremba, P.iotr (2010). *Alfabet braci Kaczyńskich*. Kraków: Wydawnictwo M. p. 259

[17] Solidarity Electoral Action (Polish: Akcja Wyborcza Solidarność, AWS) was a political party coalition in Poland.

was one of the founders of this coalition[18]. He argued that "TKM", an informal "fraction" of AWS, has become demonstrably too prominent. This "fraction" was characterized by relentlessness in acquiring government positions and simply replacing his predecessors to gain the benefits of their position without making reforms[19].

In the 2015 election campaign, Law and Justice attacked the previous coalition government for using SOEs as their private manor and filling all vacancies with politicians. Earlier, in 2014, Law and Justice leaders showed their disapproval and outrage when Igor Ostachowicz, one of the closest advisors to Donald Tusk, landed on the board of PKN Orlen. Jarosław Kaczyński noted: "*I think it's about their arrogance, their instinctive arrogance. Later we can observe their reactions, they step back, because it's a disgrace, scandal, but it's their intuition. Intuition that comes from a deep contempt for the society, total negligence of ordinary human beings, identification only with a narrow group that is on the very top of the economic ladder*[20]".

Law and Justice also used an example of Donald Tusk's son who got a job in the Gdańsk Airport. But there were more: Aleksander Grad, the former Minister of State Treasury got a lucrative job in PGE Energetyka Jądrowa and his daughter-in-law was employed in PGE Dystrybucja Lublin. Joanna Mucha, the former minister of sport, appointed an owner of a beauty salon as deputy CEO of the the Central Sports Center.

[18] Later Kaczyński stated that the term "TKM" was invented by Marek Kuchciński.

[19] https://en.wikipedia.org/wiki/TKM_(Polish_term)

[20] http://wiadomosci.dziennik.pl/polityka/artykuly/531940,kolesiostwo-po-nepotyzm-pis-misiewicze-i-tkm-kazda-partia-u-wladzy-robi-to-samo.html

This "list of shame" of the previous government is quite long. It helped Law and Justice – a party with anti-corruption and anti-elites image – to win recent elections. Polish citizens expected moral renewal, transparency in nomination, and respect toward state money. What Law and Justice offered, however, fell short of expectations.

CRONYISM IN SOEs: THE MISIEWICZ CASE

In September 2016, the Law and Justice government faced one of its most serious PR crises for its appointments to SOEs. The original focus was the controversy surrounding 26-year-old Bartłomiej Misiewicz, a close advisor to Defense Minister Antoni Macierewicz, following his appointment to the supervisory boards of two SOEs in spite of his lack of relevant qualifications. Misiewicz, a former pharmacy assistant without a university degree, was the defense ministry spokesman and close aide to the minister. He sometimes represented Macierewicz at military ceremonies and was addressed as "minister," which drew strong criticism.

In December 2015, Antoni Macierewicz had Misiewicz direct a late-night raid by Polish military police on a NATO counterintelligence center in Warsaw[21], an incident that peaked in an investigation by the office of the prosecutor general and drew criticism from the NATO allies' side[22].

He was also given jobs in the defense industry[23]. He was appointed to the supervisory board of Polska Grupa Zbrojeniowa,

[21] https://www.theguardian.com/world/2015/dec/18/polish-military-police-raid-nato-centre-warsaw

[22] http://wbj.pl/slovakia-criticizes-poland-over-raid-on-nato-center/

[23] Poland's *Rzeczpospolita* and *Fakt* dailies reported that Misiewicz had landed a PLN 50,000 (EUR 11,770) monthly salary – astronomical compared with average Polish wages – for working in a senior communications

> MISIEWICZ BECAME A SYMBOL OF LAW AND JUSTICE CRONYISM, AN OBJECT OF LAUGHTER AT AND INSPIRATION FOR ENDLESS MEMES

one of the largest defense consortiums in Central Europe. The company's bylaws require that board members should have college degrees, but the rules were changed to allow Misiewicz to join the company[24].

Thus, Misiewicz became a symbol of Law and Justice cronyism, an object of laughter at and inspiration for endless memes. Opposition and public opinion started using his name (in plural "misiewicze") to describe all incompetent government loyalists employed in the public sector, having a negative effect on the party. Although it made Jarosław Kaczyński angry, Minister Macierewicz was vehemently defending his protégée.

Eventually, Misiewicz asked Minister Macierewicz to be suspended in his functions following allegations (which he denied vigorously) that he had offered a paid position in an SOE to an opposition councillor in exchange for him joining a local coalition with his party. He resigned as a member of Law and Justice the next day. Speaking to journalists, Misiewicz said that a "dirty campaign" by the media against him had attempted to tarnish "all the successes of the government of Prime Minister Beata Szydło, especially the social ones which improve Poles' lives".

Misiewicz lost his job, but his friends from Law and Justice quickly found him a new one. He landed softly in TV Republika, an ultra-conservative TV channel. But there is one thing he did not lose – the Golden Medal of Merit for National Defense. The medal recognizes meritorious service which strengthens the military of the Republic of Poland. When a 27-year-old would-be pharmacist was decorated with it, the military — and public opinion — was shocked and outraged. When the truth about his career came out and he was fired with a loud bang, no one deprived him of the medal. The Nowoczesna party wrote an official letter to the minister to do so. But Deputy Minister Bartłomiej Kownacki[25] answered that this would not be possible.

role for PGZ. The company denied the reports about his salary.

[24] Misiewicz's rapid career contributed to straining of civil-military relations after Law and Justice took office in 2015. Minister of Defense Antoni Macierewicz has implemented wide-scale staffing changes at the highest levels in operational units, replacing officers selected by Civic Platform. In the general staff, these changes encompass 90% of command positions, and 82% in the General Command. After his own shocking dismissal, Miroslaw Rózanski, General Commander of the Polish Armed Forces, pointed out the absurdity: "I received my first star from President Aleksander Kwasniewski, the second from Lech Kaczynski, and the third from Bronislaw Komorowski." Only Komorowski was with Civic Platform. General Waldemar Skrzypczak — the former commander of Poland's Land Forces and of Multinational Division Central-South in Iraq —was fired from the Military Institute of Armament Technology. Additionally, the government created of a new territorial defence force aimed at deterring a possible Russian attack that critics say could end up serving as the armed wing of the ruling right-wing Law and Justice party. The force would be made up of 53,000 part-time soldiers stationed throughout the country by 2019. That would constitute a third of all Polish military personnel. According to the government's plans, in addition to their military duties the units will have responsibility for "anti-crisis measures, anti-subversion, anti-terrorism and anti-disinformation in defence of civil security and the cultural heritage of the Polish nation".

[25] Another golden boy of Antoni Macierewicz. Recently

POLITICAL FRIENDS AT SOEs

In March 2017, the most important SOEs listed on the Warsaw Stock Exchange published their yearly financial reports for 2016. The reports include remuneration of executive board and supervisory board members.

It is interesting to review data of key companies, such as:

- Polski Koncern Naftowy Orlen (PKN Orlen; oil refinery and petrol retailer),
- Polskie Górnictwo Naftowe i Gazownictwo (PGNiG; oil and gas company),
- Powszechny Zakład Ubezpieczeń (PZU; insurance company),
- KGHM Polska Miedź (mining and metallurgy company),
- Tauron Polska Energia (energy company),
- Powszechna Kasa Oszczędności Bank Polski (PKO BP; bank),
- Grupa Lotos (refinery and petrol retailer),
- Polska Grupa Energetyczna (PGE; energy company),
- Polski Holding Nieruchomości (PHN; real property company),
- PKP Cargo (cargo railway company).

They are especially important because companies listed on the stock exchange are subject to detailed scrutiny by financial authorities and the media. They should carry out transparent accounting and employment policy. Nevertheless, 38

> LAW AND JUSTICE POLITICIANS UNDERSTOOD THAT BEING A MINISTER WAS A VULNERABLE POSITION AND IT WAS BETTER TO MOVE FROM GOVERNMENT TO SOEs, WHERE THE REAL MONEY IS AND WHERE FRIENDS COULD BE HIRED

board members of these companies were closely connected with the Law and Justice party or the United Poland party of Minister of Justice Zbigniew Ziobro[26]. According to OKO.press (a non-profit fact-checking project financed by the largest liberal media holding, Agora), those enterprises paid in 2016 PLN 28.5 million (EUR 7 million) to PiS nominees. Some individuals, former MPs, and council

FAZ accused him of having links with pro-Kremlin far-right groups. http://www.faz.net/aktuell/politik/ausland/polens-regierung-pflegt-enge-kontakte-zu-russland-15100209.html

[26] Alternatively translated as "Solidarity Poland". The party was founded in 2012 by Law and Justice MEP Zbigniew Ziobro, who led the party's conservative Catholic-nationalist faction. Since 2015, United Poland has been in coalition with Law and Justice.

members, earned around PLN 2 million in 2016. The leader of this ranking was Wojciech Jasiński.

Shortly after Law and Justice's election victory in 2015, the supervisory board of Poland's biggest fuel group, PKN Orlen, dismissed CEO Jacek Krawiec and appointed Jasiński, a former Law and Justice MP, to the post. He gave up his seat in the parliament immediately after the nomination. It is not very surprising. Being an MP, he would earn some PLN 150,000. Now, however, his income is about PLN 3.3 million!

In 2016, Prime Minister Szydło unexpectedly liquidated the Ministry of State Treasury by technically firing its head, Dawid Jackiewicz. With the move, Law and Justice politicians understood that being a minister was a vulnerable position and it was better to move from government to SOEs, where the real money is and where friends could be hired. Jobs in such enterprises became choice morsels for different faction leaders within the administration.

According to the media, battles between government members for the best positions in SOEs became as fierce as the ones after eight years of the PO-PSL ruling coalition. Law and Justice's politicians felt that their government would not last eight years, so they had to act quickly. Previously, too, CEOs could complete their teams themselves. Now, however, even that is not possible because each team must be composed of members of different party factions.

No one wants to work and take strategic decisions in such an environment. Now it is all about marketing and delegating tasks. Law and Justice MPs admit that there is only one competent person needed on each board, the one who is responsible for finances[27]. Everyone else can be unskilled, but must have strong political backing[28].

MONOLITHIC CRONIES?

Internal fights over positions in SOEs damaged the image of the Law and Justice camp as a monolith. A delicate balance inside the "Good Change Team" – as they like to call themselves – was compromised by Mateusz Morawiecki, who joined the government in 2015 as an outsider but got full support from Jarosław Kaczyński, together with unlimited control over the Polish economy.

He has since been perceived as Kaczyński's successor. Mateusz Morawiecki brought about the dismissal of PZU CEO Michał Krupiński, who represented Zbigniew Ziobro's group[29]. According to *Newsweek Polska*, Ziobro was furious and PM Beata Szydło supported him, threatening that she would step down. Jarosław Kaczyński himself had to intervene and Mateusz Morawiecki was banned from appointing a new CEO of the biggest insurance company in Poland.

> THE SZYDŁO-ZIOBRO DUO IS PLAYING TOGETHER AND RECENTLY HAS WON CEO POSITIONS IN PEKAO BANK AND ALIOR BANK FOR THEIR FRIENDS

On the contrary, the prime minister won bigger influence over nominations and PZU was given to another ally of Zbigniew Ziobro. The Szydło-Ziobro duo is playing together and recently has won CEO positions in Pekao bank and Alior bank for their friends. Some commentators say the coalition in SOEs is the basis for a long-standing alliance in the party that aims at replacing the old leader.

Internal fights bring instability to key companies in the most sensitive sectors of the Polish economy. Since November 2015, some companies have witnessed numerous CEO changes. For example, Energa, an energy company in Gdańsk, has already seen its fourth CEO. The first one was an expert, so he lost his job after a couple of weeks. He was replaced by a former CEO of SKOK Krapkowice[30], not related to the energy sector before but well-connected with the minister of state treasury.

There is only one powerful CEO nominated by the former government who has kept his job. Zbigniew Jagiełło, CEO of PKO BP, became Methuselah in this sector. However, it is not only due to his management experience and skills but also due to his membership in the anti-communist radical group Fighting Solidarity, led since 1982 by Kornel Morawiecki[31], father of Mateusz Morawiecki.

FINANCIAL CONSEQUENCES FOR SOEs

What are the consequences of these nominations for the financial results of SOEs? They are significant and surprising at first sight. Some commentators created even a new stock market called *WIG PiS*. WIG PiS is an index of the 20 biggest state-owned companies managed by Law and Justices' nominees. According to all analyses, this index is doing great. It was the best investment in recent years. Market capitalization of SOEs grew from PLN 232 billion in October 2015 to PLN 268 billion in May 2017 (+PLN 36 billion). WIG PiS grew by 17.8%, compared to 7.9% of WIG20.

So maybe Jarosław Kaczyński and Beata Szydło were right and chose great managers who simply happened to be Law

[27] https://wiadomosci.wp.pl/tylko-w-wp-walka-o-wplywy-w-panstwowych-spolkach-sie-zaostrza-tylko-dyrektor-finansowy-musi-byc-kompetentny-6127895061457025a

[28] We can also observe another battle between a few ministers to dominate the boards. Since Dawid Jackiewicz was eliminated from this game, the faction of Matuesz Morawiecki is competing with Krzysztof Tchórzewski, minister of energy. The competition is connected with the fact that, since January 1, 2017, the Ministry of State Treasury was liquidated and 432 SOEs were moved under control of other ministers. The minister of energy got 42 companies, (including KGHM, Enea, Energa, Lotos, Orlen, Tauron, Huta Łabędy, JSW, Kompania Węglowa, PGE, PGNiG, PAK, and Siarkopol). The minister of development got more than 240 (including PKO BP, PZU, PLL LOT, GPW, Totalizator Sportowy, Grupa Azoty, Agencja Rozwoju Przemysłu, Cefarm, H. Cegielski, Huta Ostrowiec, and Polski Fundusz Rozwoju). The minister of maritime affairs got 11 companies (including Dalmor, Polska Żegluga Bałtycka, Stocznia Szczecińska Porta Holding, Stocznia Szczecińska Nowa, Stocznia Gdynia, and Stocznia Gdańska). The minister of infrastructure got 47 companies (including Poczta Polska, Polsk Holding Nieruchomości, PKP, and PKP PLK). The minister of defense got 20 companies (including Mesko, Hutę Stalowa Wola, Stomil-Poznań, Polską Grupę Zbrojeniową, and Polski Holding Obronny).

[29] Kurpiński also represented very personal interests of Ziobro, hiring his brother Witold Ziobro and his wife Patrycja Kotecka in the PZU group. (http://www.rp.pl/Rzad-PiS/170409892-Brat-Ziobry-otrzymal-posade-w-PZU.html)

[30] SKOK – Cooperative Credit Savings Association, a network of credit unions close to Law and Justice.

[31] A member of Polish Parliament, serving his 8th term of office. In the 2015 Sejm election, he was first-place candidate on the Kukiz'15 electoral list of Paweł Kukiz in the Wrocław electoral district. He was involved in a Sejm scandal in April 2016, when Morawiecki left his Sejm member card in the voting device after feeling ill and exiting the debating hall, resulting in MP Małgorzata Zwiercan casting his vote for him. Following the scandal, he left Kukiz'15 and began organizing his own party along with Małgorzata Zwiercan, who had been expelled from the Parliamentary club.

> COMPANIES IN THE HANDS OF PARTY LOYALISTS CANNOT BE INNOVATIVE AND COMPETITIVE ON THE GLOBAL MARKET – THEY ARE NOT ORIENTED TOWARD MAXIMIZING PROFITS IN THE LONG RUN. THEY ARE ORIENTED TOWARD PRESERVING THE STATUS QUO

and Justice's politicians at the same time? Not really. The growth is a bounce after months of falls and uncertainty before the 2015 elections and post-elections transition period when investors, fearing Law and Justice, withdrew their money from the Warsaw stock market. It is also connected with global growth and general optimism among investors.

The global demand for steel moves higher and the price of coal is growing. Also, copper prices have been growing recently worldwide. For Polish coal companies (an important component of WIG PiS), 2016 was rather good, but it should be stressed that some previous years were much better (JSW earned PLN 4.4 million net in 2016, but in 2011 it was PLN 2 billion). Good results of oil companies are due to limitations on the illegal import of Russian oil, and a general good economic trend. The latter one started in Poland before Law and Justice came into power, at the turn of 2013 and 2014. The Szydło administration accelerated it with its flagship social program "Family 500 Plus"[32]. That program costs the state budget a gigantic amount PLN 23 billion in 2017 alone. Families spend the vast majority of those benefits on consumption, including new cars, which leads to the improvement of the financial results of the PZU insurance company.

What looks like a great success of the government employment strategy is an illusion. SOEs are packed by incompetent politicians who lack clear visions and focus on PR or marketing. Their success will end alongside deterioration in the international economic environment, or with budget difficulties connected to overspending.

[32] The "Family 500 Plus" program envisages PLN 500 for every second and consecutive children regardless of household income, as well as for the first child in households with incomes not exceeding PLN 800 per capita monthly, or PLN 1,200 if the child is disabled.

ON THE LOCAL LEVEL

The wind of change blew not only for national champions in Warsaw. A gentle wind of public money for Law and Justice's loyal activists flew over Poland from the Baltic Sea coast to the Tatra mountains. Year 2016 was one of great economic success for PiS and its coalition parties' members in all Polish cities, towns, and villages. Many of them found new well-paid jobs – from the state or local budget, of course. Others were rapidly promoted, benefiting from wage increases not available (or imaginable) to regular citizens.

Nowoczesna analyzed personal property declarations of Law and Justice councillors on the municipal, county, and regional level, and announced the results during press conferences around the country. It further provided examples of regional councillors whose income is now 20 times higher than in 2015 because of new SOE contracts. Nowoczesna's campaign ("Councillor Plus") received big media attention and was creatively developed by media such as. *Gazeta Wyborcza*.

The first impression after studying these materials is that the best way to get a lucrative job is to have an education in property management and theology. That is, for instance, exactly the profile of Law and Justice's city councillor from Cracow, Paweł Terlecki, who got a job in 2016 in a local company called Opakomet (controlled by the state) and earned PLN 100,000. Terlecki was hired immediately after the 2015 elections by his party-mate. He is a specialist in canon law and had nothing to do with the production of plastic wrapping, which is what Opakomet does.

Cezary Jurkiewicz is another example. This Warsaw city councillor and president of the local "*Gazeta Polska*" Klub[33] was nominated in January 2016 by his colleague-minister of sport for chairman of the National Sport Center[34]. He had not had anything to do with sports or sport management. He graduated from Warsaw Theological Academy. For 12 years, he managed cafes. His new position at COS gave him more than PLN 200,000 in 2016. But it was not enough! In 2017, he was promoted again and became the first chairperson of a newly established Polish National Foundation, a public organization whose main goal is to fight stereotypes against Poles all over the world, with a budget of more than PLN 100 million coming from "donations" from the biggest SOEs. Such examples can be multiplied.

It can be easily concluded that nowadays in Poland, it is not skills, competency, or experience that decide promotions and bonuses in SOEs. It is having friends and family members in Law and Justice.

EMBARRASSMENT AND ALL THAT

It has always been like that – some Law and Justice members say to cut discussions about their party's nepotism. It means they are hopeless and hitting a dead end. Using SOEs as a source of patronage is a problem that all ruling parties in post-1989 Poland have encountered. However, the allegation that Law and Justice tolerates cronyism is especially damaging, even more than the crises over the freedom of media or independence of the judiciary. It demolishes Jarosław Kaczyński's claim to stand for the moral renewal of Poland and Polish elites.

[33] A local discussion clubs organized by readers of right wing, nationalistic weekly magazine *Gazeta Polska*, unconditionally supportive towards the Law and Justice government.

[34] Centralny Ośrodek Sportu (COS). Its main goal is to prepare sportsmen and sportswomen for the Olympics.

In 2015, one of the most important points in Law and Justice's election program was to stand up against standards of the previous Civic Platform administration representing an out-of-touch and complacent establishment (so-called "fat cats") tainted by scandals. Jarosław Kaczyński and his disciples have failed miserably and lost the legitimacy to call themselves "pure defenders" of public morality.

Many Poles laugh at *misiewiczs*, feel embarrassed, or even shattered. But it is important that we understand those people are responsible for key companies in Poland that influence the growth and national security of the country. Companies in the hands of party loyalists cannot be innovative and competitive on the global market – they are not oriented toward maximizing profits in the long run. They are oriented toward preserving the status quo. They cannot be left in the hands of greedy apparatchiks. Firing them is not enough to clean up the situation. All connections between the SOEs and *external* consulting, PR, or marketing companies owned by party officials must be cut and investigated by independent authorities, as cases of acting against the company's interests are very likely to be proven.

LIBERAL RESPONSE

What should be the liberal answer to this pathological situation? The simplest one that will cut connection between politics and the companies is privatization. Privatization has been one the most important driving forces behind the economic success of Poland after 1989. However, in the 2010s, the process has lost its momentum.

The former government attempted to generate privatization revenues but simultaneously tried to supervise more companies. The current government, with its nationalist and statist sentiment, is forcefully against privatization. Cronyism is only one of the negative consequences of this trend[35].

Liberals should overcome the pressure of self-interest groups and political parties, and offer a clear and transparent privatization plan based on experiences from the past[36]. For the companies that will stay in the hands of the state (it is clear that not all of them can and should be privatized because some play a crucial role for national security), the rules of employment must be clear and immune from political influence. ●

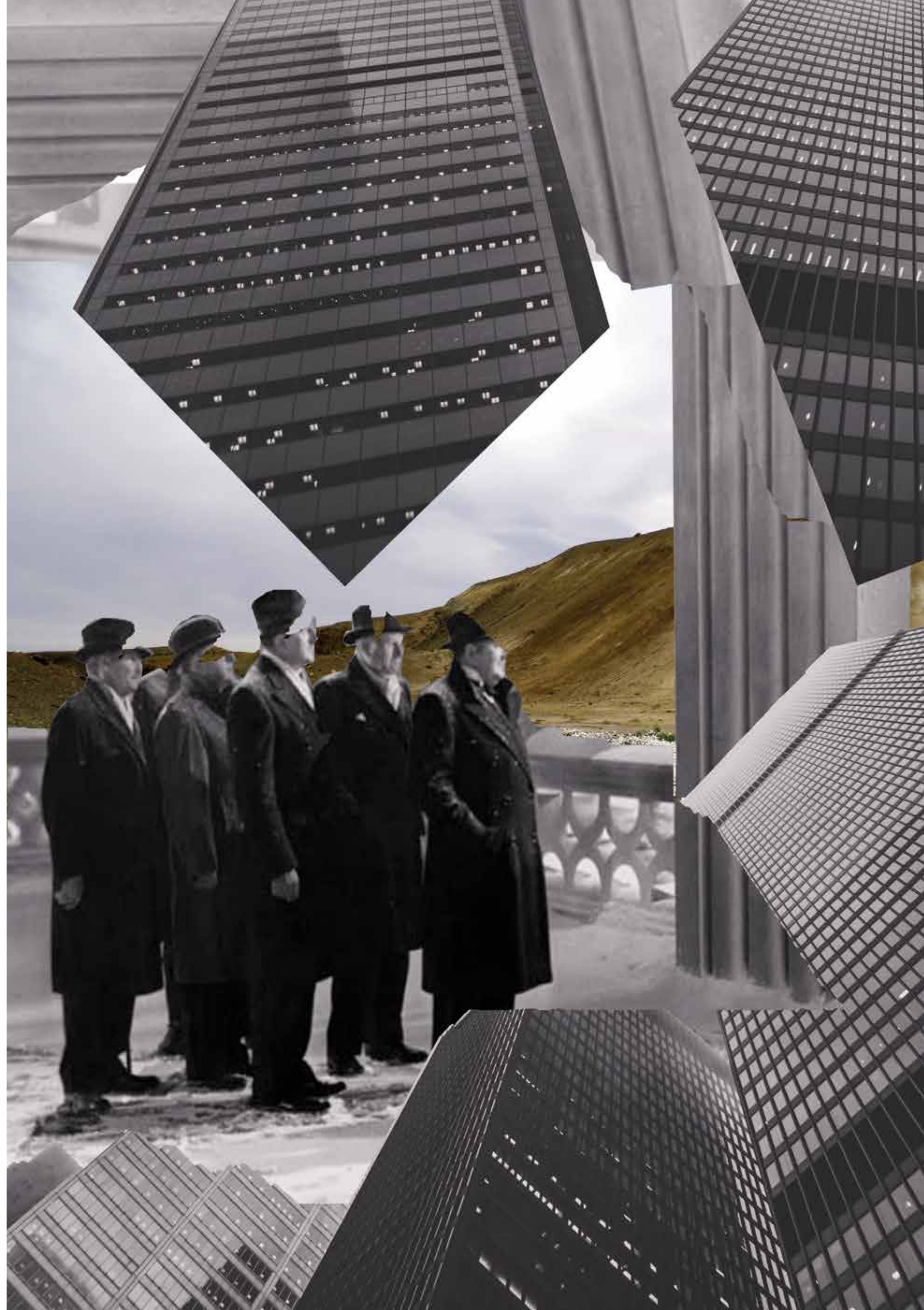
35 It can reduce competition, give way to political rent seeking, and weaken the functions of market institutions.

36 To avoid potential abuses, eg. undervaluation of companies, lack of transparency, and possible corruption schemes.

*

ADAM SZŁAPKA

Member of Parliament, Secretary General of Nowoczesna (Modern), a Polish liberal party. He is a member of the Foreign Affairs Commitee and the Commitee for Special Services, as well as the Chairman of the Parliamentary Group for the Future of the EU.



Crony-Owned Enterprises in Hungary

*
ESZTER NOVA

The state's influence on the economy through company ownership is a peculiar issue. The Hungarian state's share in the economy is high – but mostly in line with other countries. What stands out among OECD countries is the number of companies owned par-

> WHAT THE STATISTICS – AND MACROECONOMISTS – CANNOT MEASURE IS HOW MUCH OF THE ECONOMY IS RUN NOT BY THE STATE, BUT BY CRONIES

tially or wholly by the state that attests to some degree of micromanagement. But state-owned enterprises (SOEs) are just part of the problem. What the statistics – and macroeconomists – cannot measure is how much of the economy is run not by the state, but by cronies. SOEs have a massive problem of not having to respond to market forces and becoming vehicles of rent-seeking. But crony-owned enterprises (COEs) are not driven by market logic either. If SOEs are less motivated to serve customers and deprioritize market demands in favor of easy public money, COEs are no better. Transparency and legal sheltering by the state are issues for both types of enterprises. The only difference between SOEs and COEs is that COEs are not meant to

> WHEN IT COMES TO THE NUMBER OF COMPANIES OWNED BY THE STATE, THOUGH, HUNGARY LEADS BY A GIGANTIC MARGIN

benefit the budget or the public. They are a step backwards, even from a state-controlled economy (misleadingly called state capitalism).

HUNGARIAN STATE IN THE ECONOMY

According to OECD statistics, the share of the state in the Hungarian economy is large, but similar to other countries. When it comes to the number of companies owned by the state, though, Hungary leads by a gigantic margin.

According to 2012 OECD data, Hungary led OECD countries by number of SOEs, responsible for about 5% of state-dependent employment. The Hungarian state owned no less than 371 companies partially or

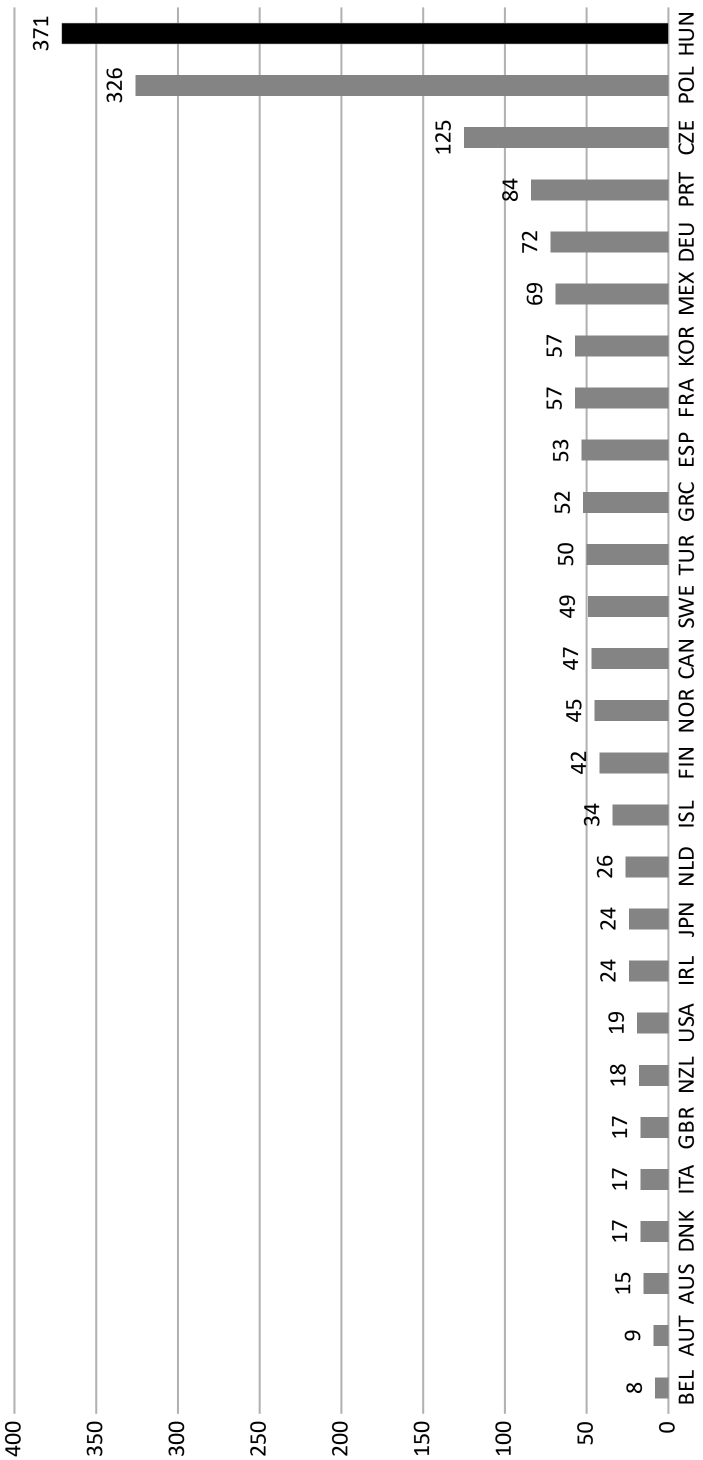


Figure 1: Number of state-owned enterprises (SOEs) in 2012

Source: OECD, 2014

> PRIME MINISTER VIKTOR ORBÁN HAS AN EXPLICIT GOAL TO CEMENT HIMSELF AND HIS CRONIES IN ECONOMIC POWER AND TO INCREASE THE INFLUENCE OF FIDESZ IN THE ECONOMY

wholly, followed by Poland (326 SOEs), Lithuania (137 SOEs), and the Czech Reublic (125 SOEs), among OECD countries [See Figure 1].

The data is startling, especially considering that the situation has worsened since 2012 when the data was assembled. The Fidesz-led Orbán government has since moved into the utilities market, for instance, by introducing price controls and making life difficult for private and foreign owners of utility companies. The move did not just make domestic energy and utility prices stay high during the general downward trend in Europe – leaving Hungary one of the most expensive countries for energy in Europe – but also chased many of these utility providers out of business, their assets returning to the state or to well-connected cronies.

THE SIGNIFICANCE OF COES IN HUNGARY

However, SOEs are just part of the story. Prime Minister Viktor Orbán has an explicit goal to cement himself and his cronies in economic power and to increase the influence of Fidesz in the economy. The goal is to essentially create a party-state, and SOEs and COEs are part of his plan.

COEs and other curiosities, legally, might look like private market players, but are detached from market logic and rely on political connections, laws written for them, and other unfair means. When they misbehave or fail in business, political connections shelter them.

Nor are those the old state-mandated monopolies; new forms of COEs include licensed industries. But everything is always perfectly legal – to silence watchdogs and critics who yearn for an excuse to avoid confrontation.

CRONIFICATION OF THE ECONOMY

The question of where cronification hides in the economic statistics touches on the nature of SOEs and state capitalism. Is state capitalism a way-station to a more-private economy? The best SOEs have demonstrated that they can thrive without the instructions of the state – but the worst have proven that, however many market disciplines imposed upon them, they will find a way of turning state capitalism into crony capitalism.

So is cronification a step toward privatization, or is it merely rent-seeking by politically well-connected individuals? Given that many of the companies started as genuine businesses before they went

[1] OECD (2014), The Size and Sectoral Distribution of SOEs in OECD and Partner Countries, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264215610-en

> EVERY WELL-EXECUTED THEFT OF FREEDOM AND CONTROL GIVES THE VICTIMS A WAY TO FEEL THEY CAN GET ON BOARD WITH THE THEFT

bankrupt, then were sold to cronies who knew how to make the law that broke the business go away, the answer seems obvious.

Globally, is state capitalism a step toward the real thing, before the private sector regains control – or a step toward full-blown cronyism?

Does it create real economic value – or is it paper value designed to make its beneficiaries rich while socializing risks and losses? Above all, who are those beneficiaries?

FEELING HELPLESS? JUST ROLL WITH IT!

When people feel helpless, they can choose to become angry and eternally frustrated, or change their minds about it. Every well-executed theft of freedom and control gives the victims a way to feel they can get on board with the theft.

There has been a small craze on the Budapest Stock Exchange (BUX) lately. People who never took an interest in playing the stock market now rush to buy stocks – because they feel they can predict what will happen (like the retail investors in Budapest rental property funds). The reason for this craze is that the world's best-performing stock just happens to be Hungarian and listed on BUX.

However, this miraculously performing company is not innovative. In fact, it has been languishing in penny-stock territory for most of its existence. Then something happened.

"Kids, state funding is about to pour in and the stock price will go skyward!" wrote an anonymous trader on an online forum when Lőrinc Mészáros, Orbán's new "oligarch-in-chief", bought a stake in Konzum.

"Sales at Hungarian conglomerate Konzum Nyrt. dropped 99% last year, its short-term debt ballooned sevenfold, and it cut its staff by 86%. This year? Konzum has the world's best-performing stock, its shares soaring more than fiftyfold on the Budapest exchange at one point. The company has a market value of about USD 142 million", a journalist wrote in *Bloomberg*[2]. Konzum is neither innovative nor productive. It does not hold valuable patents, it did not invent anything. It does not even make prodigal profits right now. It had sales of just EUR 77,000 in 2016. It is not serving clients well, and has no flashy plans to do so. It is just amassing assets right now. Its selling point? That it belongs to the Hungary's new oligarch-in-chief.

"Maybe I'm smarter" than Mark Zuckerberg, Mészáros said, a former gas repairman and mayor of the prime minister's birth village, who in February 2017 sparked the rally when he bought a 20% stake in Konzum. He credited "God, luck, and Viktor Orbán" for his success on other occasions.

[2] *What's Boosting the World's Best-Performing Stock?* Bloomberg, July 25, 2017.

> PEOPLE ARE INVESTING IN CRONYISM AND A MÜNCHAUSEN-STYLE ECONOMY BASED ON WINNING PUBLIC MONEY – RATHER THAN INVESTING IN THE PRODUCTIVE ECONOMY

After Mészáros replaced Orbán's former chief oligarch in 2014, his wealth increased fifteenfold. That makes him Hungary's fifth-richest citizen with an estimated net worth of EUR 390 million, according to the Top 100 list of *Napi.hu*, a financial daily. Companies linked to Mészáros and his family won HUF 225 billion (EUR 729 million) in public procurement contracts in 2016 alone, according to RTL Klub, the country's last major TV channel not controlled by the government.

That is enough to attract the trust and speculative hopes of even retail investors. People's savings are going into the chief oligarch's company, which specializes in winning public procurement tenders. People are investing in cronyism and a Münchausen-style economy based on winning public money – rather than investing in the productive economy.

As another sign of market sickness, the stock that seems to move BUX by sheer volume is deemed too opaque for analysts to discuss it. "Despite the popularity of Konzum's shares—its trading volume sometimes exceeds that of the Budapest Stock Exchange's four blue-chip companies combined – most brokerages have chosen not to publish regular reports and analyses about the company. Three analysts declined to discuss Konzum on the record, citing its opacity and saying they couldn't see any justification for its share price", *Bloomberg* found when inquiring into the miraculous shares[3].

CRONIFICATION THROUGH LICENSING: TOBACCO INDUSTRY

Nevertheless, Konzum is a new phenomenon, and pesky journalists did not have the time to fight their way through the courts to give the public a better picture.

In order to assess cronification from the viewpoint of tax revenues, we need to rely on another example of crony businesses defying market logic – one that had already been uncovered and documented: the case of the sudden licensing of the tobacco retail industry and the cronification of tobacco retail and distribution in Hungary.[4]

In 2015, a friend of the minister heading the Prime Minister's Office, János Lázár, won an exclusive license to supply tobacco products to the (previously also licensed) National Tobacco Stores. His company, Országos Dohányboltellátó Kft. (OD Kft.) won on an invitation-only tender for the exclusive supply of tobacco products to all

[3] Ibid.

[4] *A nemzeti újraelosztás rendszere: minden doboz cigarettán 30 forint nyereség*, Átlátszó, July 27, 2017. https://blog.atlatszo.hu/2017/07/a-nemzeti-ujraelosztas-rendszere-minden-doboz-cigarettan-30-forint-nyereseg/

tobacco stores for 20 years. Only OD Kft. was invited to the tender – despite protests from the original market players, the tobacco wholesale distributors, who had offered 10 times the amount for the license as a concession fee – but to no avail. They simply were not invited to submit an offer.[5]

But the national budget had to suffer other shortfalls, too. Most of the taxes OD Kft. is supposed to pay to the budget are channelled into spectator sports[6] – a scheme that allows corporations to send undisclosed amounts to sports (mostly football) clubs[7].

Despite the state-mandated increase of the price in now-licensed tobacco products, tax revenue from tobacco has decreased. With their new monopoly, OD Kft. made a decent profit, but paid less into the budget than the previous system.

The beneficiary of SOEs (whether created by subsidized purchase or by monopoly licensing) is undoubtedly neither the budget nor the public.

WHO PROFITS THE MOST?

There is very little reliable information on the relevance of SOEs in today's global markets and on the exact nature of the advantages they may enjoy. The political process serves to complicate ownership policy of SOEs, making them less transparent and insulating them from the legal framework applicable to other com-

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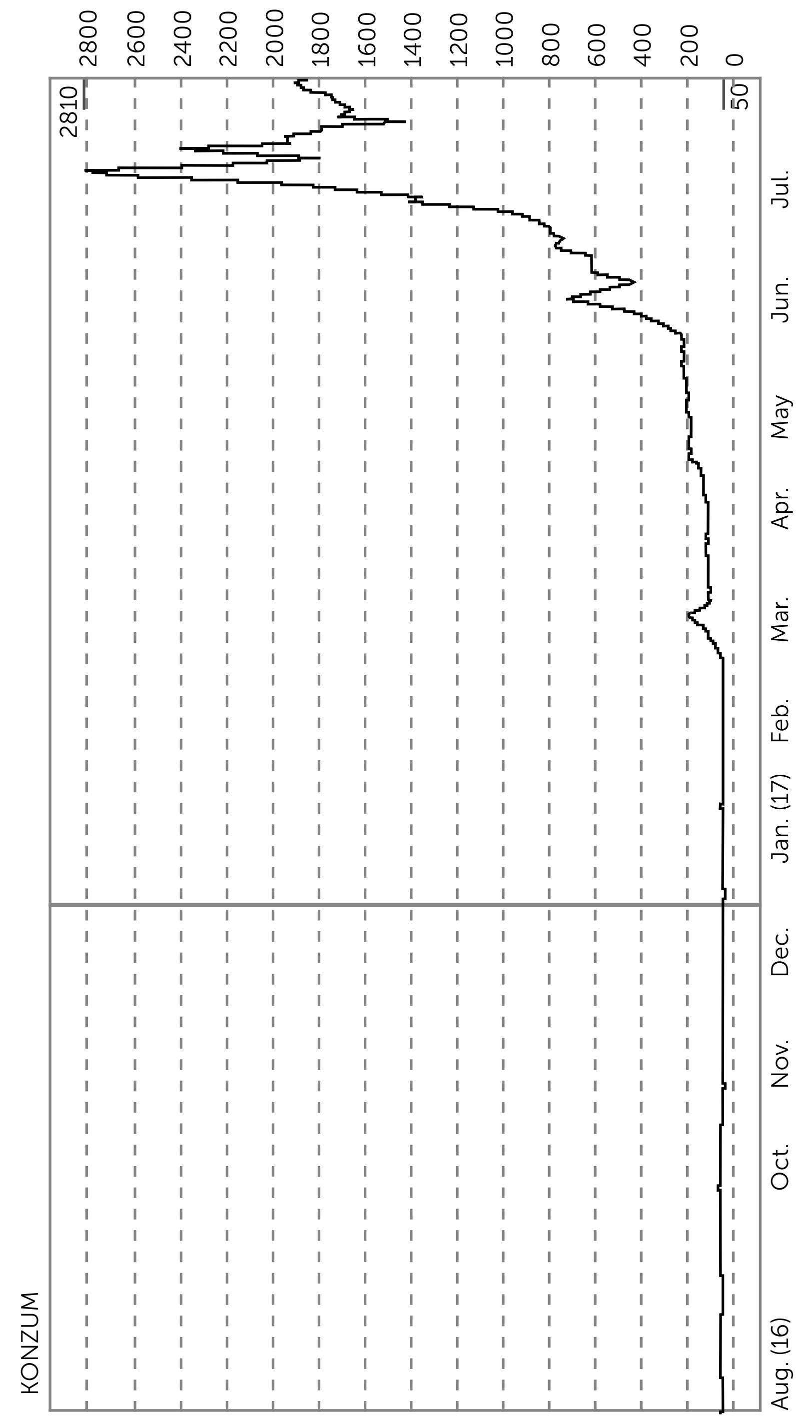
SOEs ENJOY A RANGE OF UNFAIR ADVANTAGES: GUARANTEED PROFITS, STATE BACKING, AND OFFICIAL BANKS LENDING TO THEM AT A FRACTION OF THE COST AVAILABLE TO PRIVATE COMPANIES

[5] Ibid.

[6] *Irdatlan pénz a látványsportokra: 415 milliárdot öltek bele Orbánék*, 24.hu Bita Dániel, Pető Péter, March 16, 2017. http://24.hu/belfold/2017/03/16/irdatlan-penz-a-latvanysportokra-415-milliardot-oltek-bele-orbanek/

[7] Since 2011, EUR 1.5 billion of diverted corporate tax went into sports this way – according to data obtained by journalists. The companies that feel obliged to spend their taxes this way are not disclosed, yet it is an open secret that pushing money into the prime minister's pet projects increases their chance to win public tenders.

Figure 2: Share price of Konzum since August 2016, HUF



Source: Tőzsdék & Piacok

panies[8]. However, SOEs are not a sign of economic health. Unfortunately, people tend to focus on the lame and unfulfilled promises and excuses states give when they take control of something that could be done by civilians. SOEs exist in a legal gray zone, their activities sheltered from publicity and legal obstacles that shackle ordinary businesses.

In addition to their sheer size (that escapes the attention of antitrust authorities), SOEs enjoy a range of unfair advantages: guaranteed profits, state backing, and official banks lending to them at a fraction of the cost available to private companies. The government showers tax breaks, subsidies, and special laws on state firms, and favors them in procurement contracts. All those are true for COEs, while the public benefits are even more dubious – if even applicable.

The profit motive in SOEs is not miraculously replaced by a selfless concern for the (captive) customers. Rather, a blatant disregard for its core activity develops in favor of attracting easier-to-get public money in subsidies, credit, and bailouts. The abuse of market position is the norm – even when SOEs do not get a legal monopoly. COEs are, if possible, even worse on all those counts.

In principle, national antitrust law can be used to deal with the abuse of dominant position by SOEs. It should apply to crony-owned empires as well, but not when the empire is as diverse as Konzum. Since February 2017, Konzum has acquired stakes in at least five companies with assets from campsites and banks to newspapers and media, adding to the portfolio of hotels it bought in 2016. Mészáros also controls a considerable amount of land, energy companies, and is rumored to get a piece of the Russian mega-investment in the nuclear power station in Paks.

So why is the public complacent, apart from the obvious legal sense of helplessness? Because the men on the streets hope to benefit from the political pull of the cronies. However, only one can be right. Konzum's (and Mészáros' other prodigy company, Opimus') stocks have, unsurprisingly, retreated [See Figure 2]. What no one is concerned about is creating economic value [See Figure 2].

ALARMING WORDS

The new Hungarian constitution was replaced by a Basic Law by the Orbán government in 2011. The latter portrays a fundamentally different view of the economy.

The terms "private property" and "market economy" have disappeared altogether. The old constitution stated that public and private property are equal and deserve the same legal protection. The term "market economy" is now also missing, referring to the less-than-voluntary ways of use and conveyance of property.

Given that the Hungarian government overwhelmingly consists of lawyers, they must certainly know what those terms denoted – and that they do not want that. Losing the phrase that private and public property enjoy equal legal protection is worrying. Losing the market as a means to convey property is even more alarming. And it is not just *de facto* ownership that can be misleading. Conditional ownership, or the way ownership is conveyed, can also negate the concept of private property.

[8] Including competition laws, bankruptcy provisions, or securities laws.

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HUNGARIAN BUSINESSMEN ARE ALSO SMART ENOUGH TO SPREAD THEIR INTERESTS ACROSS OTHER COUNTRIES, ALL WEST OF THE BORDER

It is one thing to keep something of private property on paper. It gives the illusion of being the nice kids. International organizations will be obliged to take their word for it, and macroeconomists will be confused to no end, sticking their quantitative noses deep into data and missing the forest for the trees. Yet the public cannot be misled. Given their sense of helplessness in setting up their own businesses due to punitive taxation, tax policing, and regulatory hostility, they try to jump on the bandwagon of the obvious winner: The company that will now win all public tenders and has been listed on the stock exchange.

Prime Minister Viktor Orbán has an explicit goal to cement himself and his cronies in economic power and increase the influence of the governing Fidesz party in the economy. The plan is enticingly called "creating a national capital-owner class", implying that they are "our" state-supported capital-owners and that it is actually good news for the people in Hungary.

Ditching *de facto* nationalization in favor of COEs is also smarter than communism because party-state regimes are organized around the opportunity to siphon public money, not to boost the state. Some cronies might genuinely believe that gaining ownership of something big was all they needed to become businessmen, but most have no illusions. Just as many Chinese and Russian strongmen are investing westwards, in countries where the rule of law is more solid and reliable, Hungarian businessmen are also smart enough to spread their interests across other countries, all west of the border. Rather than trickling down, capital put into their hands becomes private wealth stored and invested abroad.

CONCLUSIONS

If SOEs are less than motivated to serve customers and respond to market demands in favor of easier-to-get public money, crony-owned enterprises are no better. They are similarly sheltered from transparency requirements and unshackled from regulatory obstacles their market-based peers must overcome.

Every criticism of SOEs is also valid for COEs. Crony-owned enterprises may look like private market players, but they are detached from market logic and rely on political connections.

However, things get worse when we look at the purported beneficiaries of each model. COEs are not even meant to serve public goals or benefit the budget. Not only are they hidden from statistics, they are out of the government's reach – only responding directly to the party or a specific group of influencers.

The example of Konzum (and its tangled web of companies) shows how a company specializing in winning public tenders can attract a speculative mania on the stock exchange, attracting the savings of average people and making them invest in a non-productive sector of the economy. The example of the non-competitive licensing of tobacco distribution shows how those moves are not meant to benefit the public.

The Hungarian Basic Law of 2011 portrayed a novel view of the economy. The terms "private property" and "market economy" have disappeared altogether. The equal protection of public and private property has disappeared from the text. The market as a means to voluntarily convey ownership has taken a secondary role.

The proportion of the economy owned directly by the state is high in Hungary, but that fails to take into account companies that are indirectly state-controlled or otherwise serve as economic leverage for the governing party (not the state).

Prime Minister Viktor Orbán returned to power in 2010 with the explicit goal to cement the economic power of Fidesz, creating essentially a party-state. SOEs and COEs are part of his plan. This plan is called "creating a national capital-owner class", but it is doubtful whether it benefits the country or its citizens. ●

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Political Economy of State-Owned Enterprises in Poland

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ALEKSANDER ŁASZEK

Huge levels of state ownership in the Polish economy negatively affect its productivity and growth prospects. Although the employment share of state-owned enterprises (SOEs) in total employment of the Polish economy might seem limited (about 5%), their share among the largest, most important companies is much more significant.

The role of SOEs should be a source of concern, as both the simple comparison of basic indicators and research reviews indicate that SOEs are less productive than their private counterparts. The reluctance of both the current and previous Polish governments to privatize SOEs means that they will continue to play an important role in the economy.

OVERALL SIZE OF SOEs IN POLAND

Public corporations – despite their impact on competitiveness in the economy – are usually overlooked by traditional measures of the size of government. Measures such as government expenditures to GDP or public consumption concentrate on governmental units providing non-market services and transfers, but fail to consider market actors controlled by the government.

The best way to grasp the size of SOEs would be to look at the value created by public corporations. Unfortunately, although the European System of Accounts (ESA 2010) distinguishes between public and private corporations [See Table 1], separate data for them are not reported in national accounts. What is reported by the Polish Statistical Office (GUS), however, is the structure of enterprise sector, divided into public (majority owned) and private companies (including those minority-owned by the government), but without distinction between market and non-market output.

In a majority of cases it is not a problem, as government-controlled non-market producers (schools, hospitals, administration, police, or military) are not organized as enterprises and, thus, are not reported as public companies. Still, some parts of the general government are incorporated (like PLK, the Polish Railway Company) and are reported in general government statistics and in corporation statistics. Thus, one cannot simply sum the employment in general government sector and SOE, as some of them are already included in general government statistics. Nevertheless, such cases are limited, and for the purpose of this article one can assume that employment in enterprises controlled by government is a rough proxy of public corporations [See Table 1].

Enterprise sector statistics reported by GUS do not provide data on value added. The closest proxy available is the number of people employed in enterprises of dif-

Table 1: Criteria used to distinguish between public and private sector

Criteria	Controlled by goverment (public sector)	Privately controlled (private sector)
Non-market output	General goverment	NPISH
Market output	Public corporations	Private corporations

Source: European system of accounts ESA 2010, Eurostat

IN 2014, AT LEAST 816,000 PEOPLE (5.6% OF THE WORKFORCE) IN POLAND WERE EMPLOYED IN SOEs

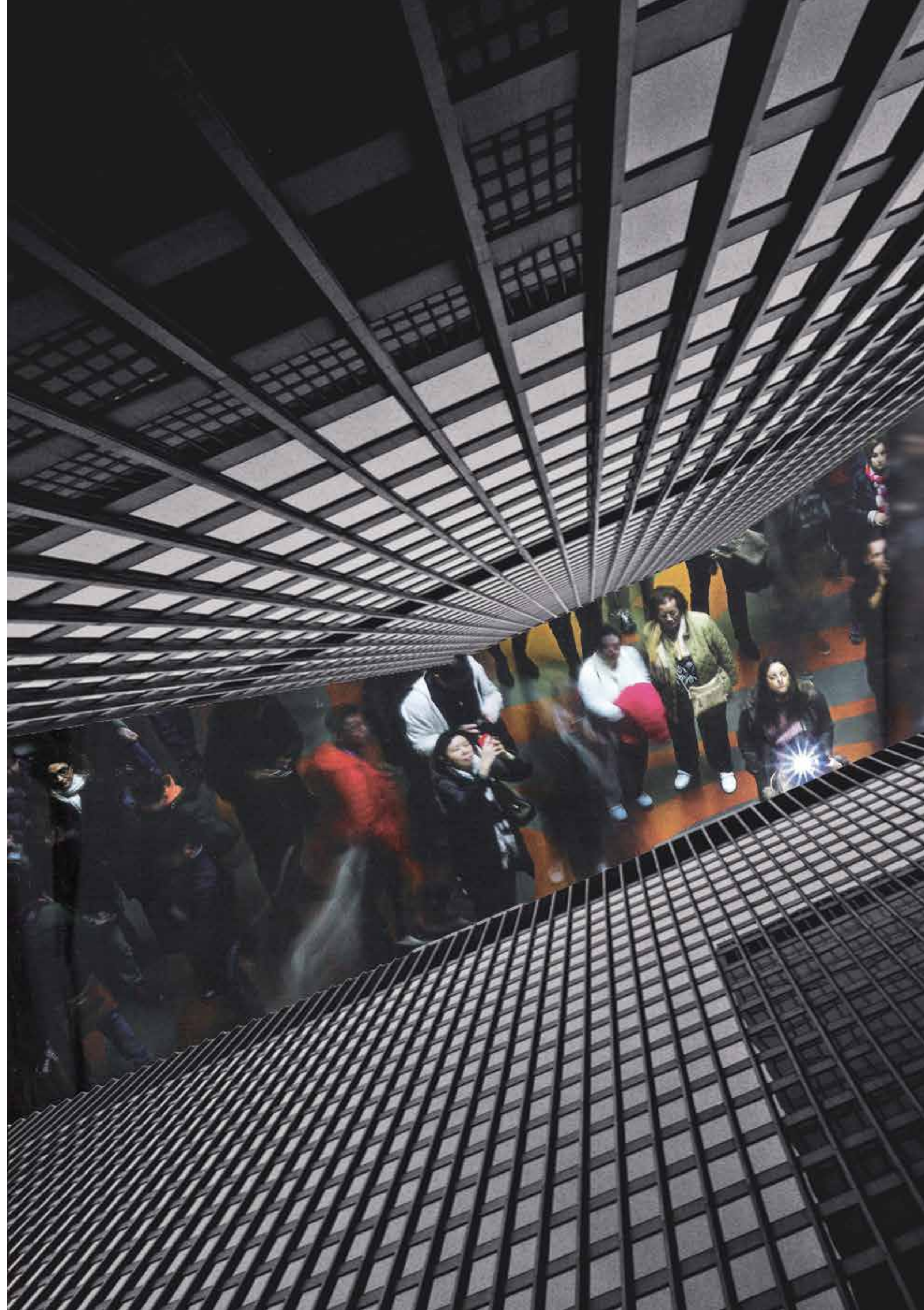
ferent classes. Thus, it is the number of people employed in an SOE, which can be regarded as a rough measure of the role they play in the economy. Data in GUS for SOEs alone are available since 2014. Unfortunately, 2014 is the last year for which data are available from the Ministry of Treasury (MoT) that provides reports on minority-owned companies, which are not covered by GUS. Considering that no serious privatization attempts have been made since 2014, this data can be used as a rough proxy for current employment in SOEs.

In 2014, at least 816,000 people (5.6% of the workforce) in Poland were employed in SOEs. This estimate is based on data from GUS and MoT. The statistical office reports employment in majority-owned non-financial SOEs employing more than nine people (630,000 employed); furthermore, another 46,000 people were employed at SOE financial companies[1]. Aggregate data for minority-owned companies are available only for companies under control of the former MoT; in 2014, 140,000 people were so employed. The total figure of 816,000 people should be regarded as a lower-bound estimate, as they do not take into account companies with fewer than nine employees, and minority-owned companies by the local government.

ROLE OF SOEs IN THE POLISH ECONOMY

Relating employment in SOEs (~800,000 people) to total employment in the Polish economy (~16,300 people) would significantly underestimate their significance. In order to properly evaluate the role played

THUS, PEOPLE WORKING IN AGRICULTURE SHOULD NOT BE COMPARED TO THOSE IN SOEs, AS BOTH GROUPS ARE AFFECTED PRIMARILY BY POLICY DECISIONS, NOT BY MARKET FORCES



[1] Of which 16,000 worked for PZU (the largest insurance company in Poland and minority-owned by the government), 29,000 for PKOBP (the largest commercial bank and also minority-owned by the government), and 1,300 for BGK (the Polish development bank that is 100% state owned).

Table 2. Overview of Polish labor market (working persons in millions as of Q1 2017)

	Total	Public sector	Private sector	
			Companies employing 10+ people	Self-employed and micro companies
Total	**16.3**	**3.8**	**5.0-5.3**	**5.3-5.5**
Agriculture	1.7	0	0.0-0.1	1.6-1.7
Non-market services *(education, health care, public administration, defense and compulsory social security, arts, entertainment, and other activities)*	3.5	3*	0.0-0.1	0.3-0.4
Business economy	11.1	0.8	5.0-5.1	5.2-5.3

**Share of public-sector employment in administration and cultural activities based on proportion from 2014.*

by SOEs, the structure and characteristics of the Polish economy and labor market should be taken into account.

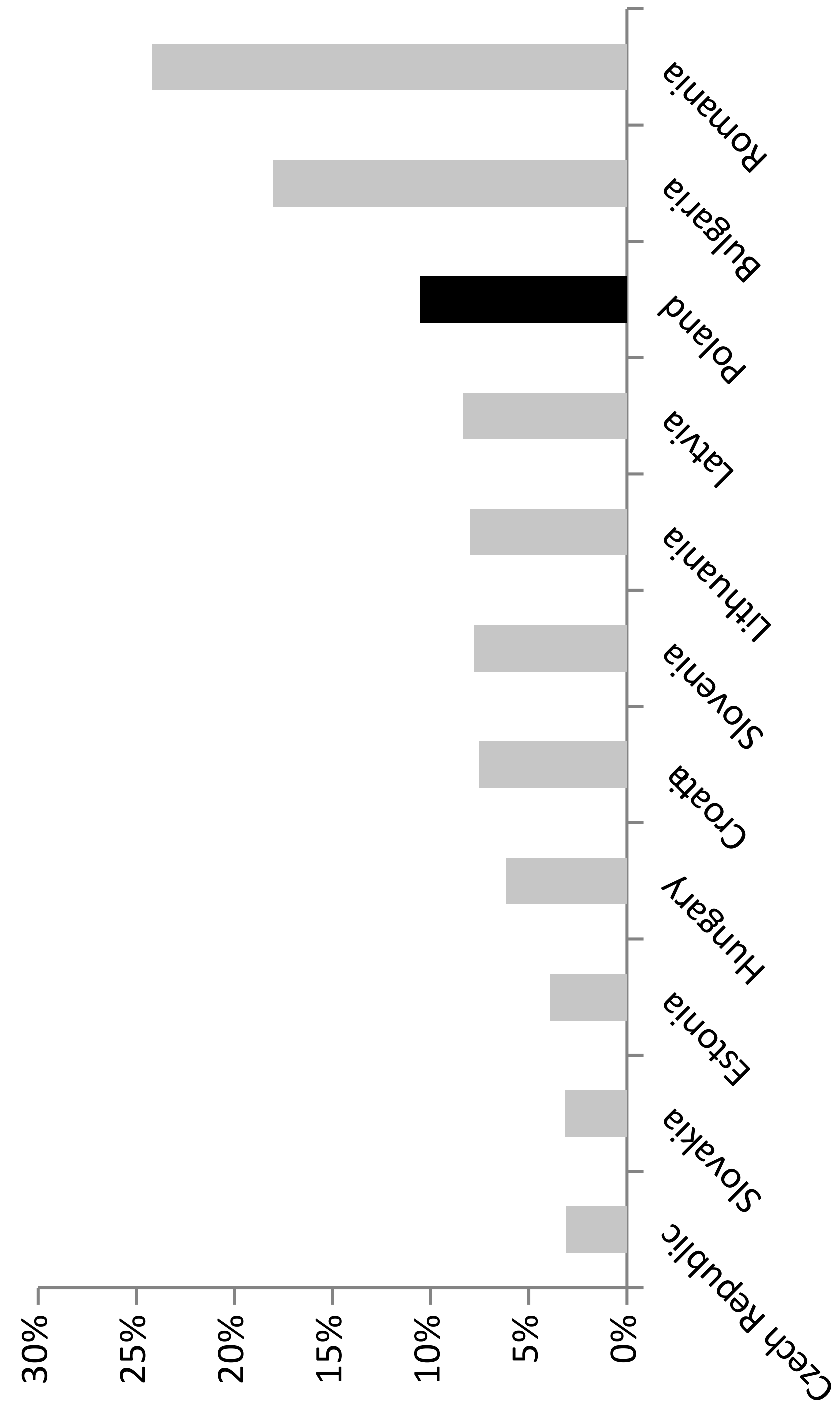
First, differences in the definition of "working person" should be taken into account. The overall figure of working persons (16.3 million) is an estimate from the Labor Force Survey (LFS) conducted by GUS, which covers 30,000 households quarterly. The estimated number of working people based on this survey is usually higher than the number calculated from company reports (in 2015, the difference was around 900,000 people for the economy). Several reasons explain the anomaly, but two deserve attention. The LFS uses a broad definition of work – it is enough to work for one hour during the week before the survey to count as working. Furthermore, LFS does not distinguish between registered and unregistered work; people working in the shadow economy are counted as working. Obviously, unregistered workers are not covered by statistics based on corporate reports.

Second, it is important to distinguish between agriculture, non-market services, and the business economy, which can be further divided into corporations and self-employed [See Table 2].

Almost all working people in agriculture work in the private sector [See Table 2], but due to numerous government interventions, efficiency is particularly low.

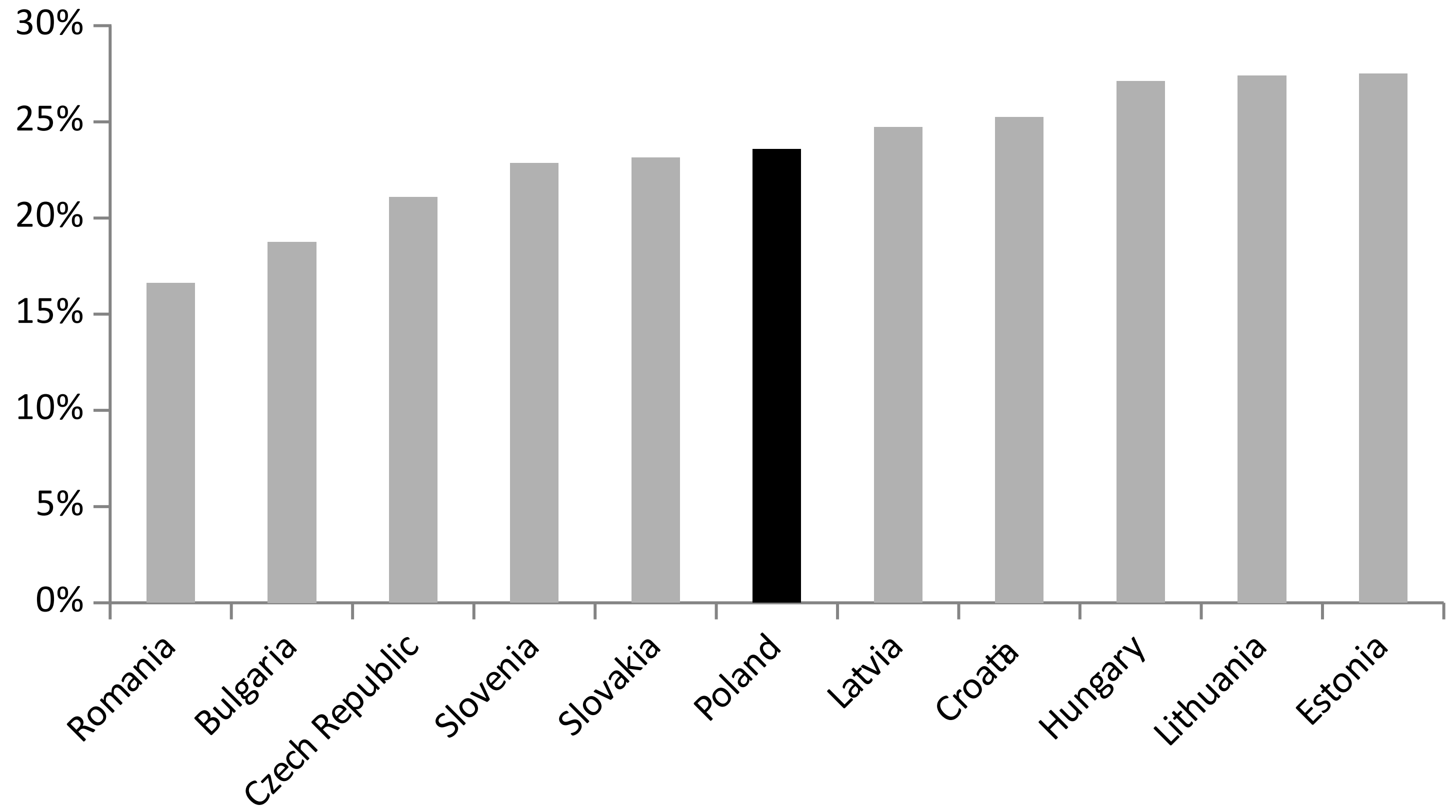
In 2016, the value added per person working in agriculture was five times lower than in other sectors of the Polish economy, while the share of people working in agriculture remains among the highest in the region [See Figure 1]. Low average productivity in agriculture masks enormous variations of scale, with efficient farms on the one hand and numerous, unproductive, micro-farms on the other. Such misallocation of resources (both workers and land) is a result of regulation (bans on land sale) and huge subsidies and tax preferences going to inefficient farms from taxpayers' pocket (more PLN 40 billion annually, about EUR 10 billion). Thus, people working in agriculture should not be

Figure 1: Share of agriculture in total employment (2016)



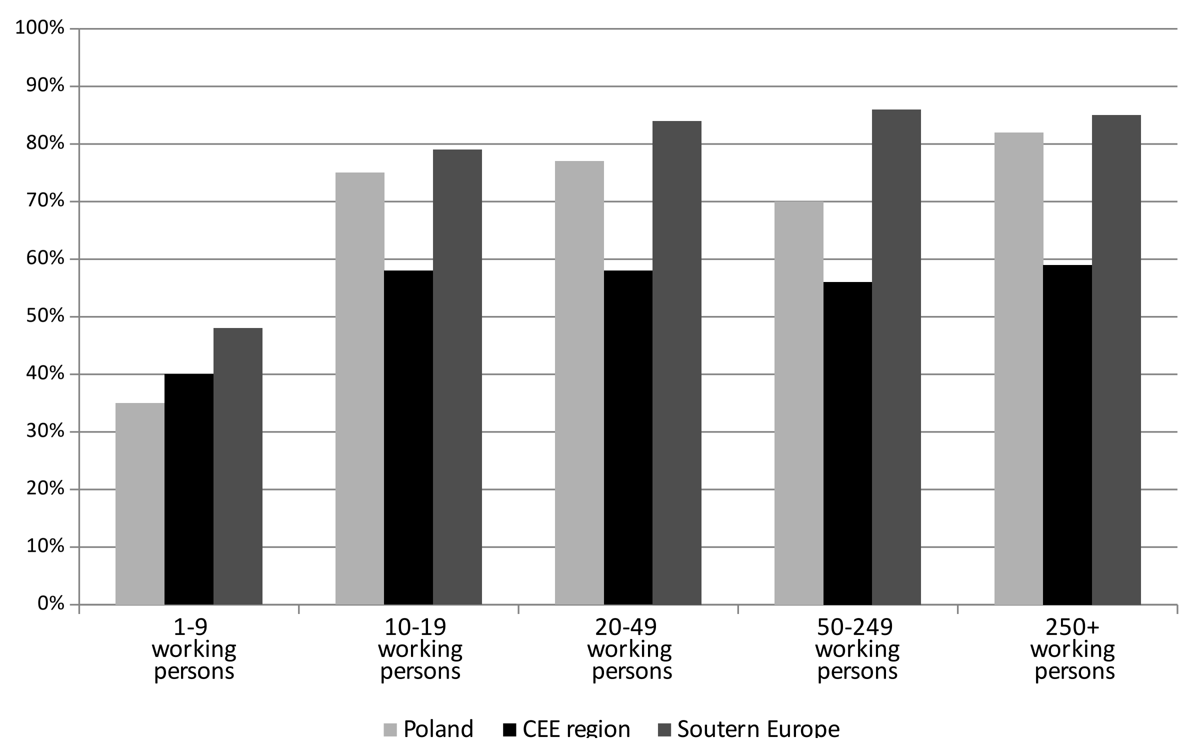
Source: Eurostat

Figure 2: Share of non-market services (education, public administration, health care, arts, entertainment, and recreation activities) in total employment (2016)



Source: Eurostat

Figure 3: Labor productivity by company size as a percentage of EU-10, 2009-2014 average



Productivity is measured as value added (EUR 2010 PPP) per working person.

CEE region encompasses: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovakia, Slovenia, and Romania.

Southern Europe encompasses: Italy, Greece, Spain, and Portugal.

EU-10 encompasses: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, the Netherlands, Sweden, and the United Kingdom.

Source: FOR, own calculations based on OECD data, value added calculated from national currencies based on Eurostat exchange rates, prices, and PPPs.

compared to those in SOEs, as both groups are affected primarily by policy decisions, not by market forces.

According to the OECD, the definition of non-market services covers services provided to the community free of charge or to individual consumers either free of charge or at a fees well below 50% of production costs. In terms of the NACE classification, education, public administration, health care, arts, entertainment, and recreation activities are usually regarded as non-market services[2]. In each part of non-market services, despite the organizational differences (public administration and education are provided by public entities; health care is partly provided by private entities but publicly funded; arts, entertainment, and recreation are mainly provided by public entities), the scope of market competition is very limited. It makes productivity measurement problematic (prices are an outcome of political bargaining, not market processes); thus, comparison of this sector with the rest of economy is challenging. It is worth noting, however, that the size of non-market services in Poland is average compared to its regional peers [See Figures 1, 2, and 3].

The business economy is the largest part of the Polish economy and in principle should be driven by market forces, but large problems with misallocation are visible. The business economy in Poland has a dual character, company size serving as the dividing line. The difference between micro-companies and companies employing 10 or more people is best visible when comparing their productivity with Western counterparts. Polish micro-companies are still much less productive than Western one, while larger companies have gradually closed the productivity gap [See Figure 3].

It should be noted that the label of micro-companies is a simplification, as this group encompass micro-companies, the self-employed, and the shadow economy. Those categories are not strictly divisive, as some self-employed also employ workers and micro-companies partially hide in the shadow economy. Although overall productivity of the micro-companies is small, some highly paid specialists register themselves as companies for tax purposes (the marginal tax rate for employed person is around 40%, while for the self-employed it is 19%).

Only around 6 million people work in the business economy of Poland in companies employing 10 people or more. Those companies constitute the backbone of the Polish economy and represent its most productive part, but employ less than half of the workforce. The share of employment in the corporate sector in Poland is among the lowest in the region and in the EU.

Changing the denominator from general employment to employment in larger companies in the corporate sector raises the share of SOEs from 5% (employment in SOEs as a percentage of workforce) to more than 15% (employment in SOEs as a percentage of employment in larger companies).

MAJOR SOEs CONTROLLED BY THE CENTRAL GOVERNMENT

The role that SOEs play in the Polish economy is even larger than it would stem from their share in employment in the business economy, as state ownership is concentrated in the biggest com-

[2] It is a simplification, as commercial activity takes place in each of the listed sectors, but it is of such a limited size that the sectors concerned are labeled non-market services. No more detailed data is readily available, as under the 1993 System of National Accounts (SNA) ,market and non-market services are not separately reported if they are involved in the same International Standard Industry Classification (ISIC) activity.

"THE BUSINESS ECONOMY IS THE LARGEST PART OF THE POLISH ECONOMY AND IN PRINCIPLE SHOULD BE DRIVEN BY MARKET FORCES, BUT LARGE PROBLEMS WITH MISALLOCATION ARE VISIBLE

panies. Of 50 biggest companies in Poland in 2016, 18 are now controlled by the government. It also controls 12 of the WIG-20 companies (Warsaw Stock Exchange index of the biggest companies) [See Table 3], either directly or through other SOEs. It should also be noted that SOEs control investment and pension funds that have shares in other SOEs [See Table 3 and 4].

POLICY ISSUES WITH SOEs

The extent of state control among the biggest companies in Poland creates serious policy issues. Rough comparisons of basic financial indicators [See Table 3] indicate that SOEs are less efficient than their private counterparts, irrespective of company size. Both revenue and gross financial result per person employed are visibly higher in the private sector in spite of larger capital outlays in SOEs. Worse results despite higher investment might be sector-specific (many SOEs are concentrated in capital-intensive sectors, like energy) or due to a low efficiency of investment. Although SOEs have a higher gross turnover profitability rate than private companies, this could be, again, due to sector specifics or monopolistic power enjoyed by them. Anecdotal evidence and the list of sectors with particularly high state ownership (mining, energy, and railways) point to monopolistic power enjoyed by them. The European Commission, in its country report[3], also notices a low return on equity (ROE) of Polish SOEs.

The intuition of the lower efficiency of SOEs in comparison to their private counterparts is confirmed in numerous studies. A useful review of the literature on SOEs can be

[3] European Commission (2017), COMMISSION STAFF WORKING DOCUMENT
Country Report Poland 2017
https://ec.europa.eu/info/publications/2017-european-semester-country-reports_en

Table 3. WIG-20 companies

Company	Capitalization (4 VII 2017) billion EUR	Book value billion EUR	Sector	% Share owned by government/SOE	% Share owned by investment/ pension funds controlled by SOE*
PKNORLEN	11.5	6.8	Primary sectors	32%	6%
PKOBP	10.2	7.9	Finance	29%	5%
PZU	9.1	3.3	Finance	34%	2%
PGNIG	8.8	7.9	Electricity and gas	72%	2%
BZWBK	8.3	4.8	Finance	-	-
PEKAO	7.8	5.5	Finance	33%	2%
PGE	5.3	10.3	Electricity and gas	57%	6%
KGHM	5.3	3.9	Primary sectors	32%	6%
MBANK	4.6	3.2	Finance	-	-
CYFRPLSAT	3.8	2.7	Other activities (Telecom)	-	-
LPP	3.0	0.5	Other activities (Retail)	-	-
LOTOS	2.3	2.2	Primary sectors	53%	8%
CCC	2.2	0.2	Other activities (Retail)	-	-
JSW	2.0	1.1	Primary sectors	55%	3%
ALIOR	1.9	1.5	Finance	31%	14%
ORANGEPL	1.6	2.4	Other activities (Telecom)	-	-
TAURONPE	1.5	4.1	Electricity and gas	40%	4%
EUROCASH	1.0	0.3	Other activities (Retail)	-	-
ENERGA	1.0	2.2	Electricity and gas	52%	3%
ASSECOPOL	0.9	1.3	Other activities (IT)	-	-

**PZU, PKOBP, and PEKAO as major financial institutions in Poland have subsidiaries in the pension fund market and in the investment fund market. Although their purpose is to make a profit for investors, it is implausible to assume that managers working in SOEs would vote different than the representatives of government.*

Table 4. Efficiency of private and SOE companies in 2015

		Total	Number of people employed		
			10-49	50-249	250+
Revenues from total activity per person employed (thousand PLN)	SOE	415	238	296	456
	Private	619	634	531	666
Gross financial result per person employed (thousand PLN)	SOE	25	7	-3	33
	Private	31	33	27	32
Investment outlays per person employed (thousand PLN)	SOE	38	30	24	42
	Private	23	12	17	30
Gross turnover profitability rate (%)	SOE	6	2.8	-1	7.2
	Private	5	5.2	5.1	4.8

SOEs defined as companies with 50% or more shares controlled by central or local government
Source: GUS

THE EC STUDY DEFINES A SOE AS A COMPANY IN WHICH THE GOVERNMENT CONTROLS 30% OR MORE OF ITS SHARES

found in Megginson and Netter (2001)[4] or Shirley and Walsh (2000)[5], who show their efficiency issues.

More recent studies come to similar conclusions. In particular, the European Commission in its study[6] on SOEs in new member states presents evidence of the lower ROE, labor productivity, and total-factor productivity (TFP) of SOEs (although such effects are not equally strong in all sectors). It should be noted that the EC study is particularly useful as it defines a SOE as a company in which the government controls 30% or more of its shares. Taking into account Polish experience, such a threshold captures real control much better than the usual 50%.

The huge involvement of SOEs in upstream sectors affects the efficiency of the rest of the Polish economy. Research by Bouis and Duval[7] shows that in OECD countries, less competitive upstream markets (more regulation and state ownership) negatively affect productivity. Poland, with particularly rigid markets (as measured by PMR[8] indicator) and rigidity driven by the high prevalence of public ownership, is among countries that can reap the biggest gains from privatization and liberalization. Bouis and Duval estimate that such reforms can increase Polish GDP by 15% within 10 years.

Quite often, the direct results of political interference into SOE management are also visible, which damages efficiency. Currently, the best example is the involvement of SOE energy companies into the support of coal mining companies.

PROBLEMATIC COAL MINES

Coal mines were restructured in Poland in the mid-1990s, but remained state-owned.

As a result of pressure from labor unions and a lack of proper corporate governance during the period of high coal prices after 2000, wages went up and investment outlays were neglected. With high wages and low-efficiency companies, they were unprepared for the fall of coal prices after 2011.

To keep the unions satisfied, politicians kept subsidizing inefficient companies at the expense of more productive ones.

[4] Megginson, W.L., and J.M. Netter (2001). "From State to Market: A Survey of Empirical Studies on Privatization", *Journal of Economic Literature* 39(2), 321-389.

[5] Shirley, M. and P. Walsh (2000), "Public versus Private Ownership: The Current State of the Debate", World Bank Policy Research Working Paper, no. 2420.

[6] European Commsision (2016), *State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context*, INSTITUTIONAL PAPER 031, July. https://ec.europa.eu/info/publications/economy-finance/state-owned-enterprises-eu-lessons-learnt-and-ways-forward-post-crisis-context_en

[7] Bouis, R. and R. Douval (2011) *Potential growth after the crisis*, OECD.

[8] Product market regulation.

When further gimmicks were not possible as coal companies ran out of money, they pressed state-controlled energy companies to "invest" into coal mines.

GOVERNMENTAL BANKING

The growing involvement of government in the banking sector is also a source of serious concern. Although the biggest Polish bank (PKOBP) was never privatized and remains state-owned, until recently it had to operate in the competitive environment of private, mainly foreign-owned banks.

Recently, however, the state-controlled PZU has taken over Alior Bank and Pekao (the second-largest bank), increasing the market share of state-controlled banks from 24% to 38% (as a percentage of total banking assets). The government argued that more involvement of domestic capital in banking sector is needed as a credit from foreign-owned banks during global financial contractions due to problems of their mother companies, while credit from domestic-owned banks proved to be much more stable[9] (Adams-Kane et al. 2017, Temesvary and Banai 2016[10]).

Although such an argument is true, it should be noted that public ownership in the banking sector is also a source of serious risks (See World Bank 2001[11] for a general overview and, for more recent research and examples, see De Marco and Macchiavelli, 2016[12]; Englmaier and Stowasser 2016[13]; Jackiewicz et al. 2013[14]; Claessens, Feijen, and Laeven 2008[15]; Damijan, 2012[16])[17]. It is noticeable that in Poland investors factor in political risks, as listed state-controlled banks have a visibly lower capitalization-to-book-value ratio compared to most of their private counterparts.

> IT IS NOTICEABLE THAT IN POLAND INVESTORS FACTOR IN POLITICAL RISKS, AS LISTED STATE-CONTROLLED BANKS HAVE A VISIBLY LOWER CAPITALIZATION-TO-BOOK-VALUE RATIO COMPARED TO MOST OF THEIR PRIVATE COUNTERPARTS

[9] See: Adams-Kane, J., Caballero, J. A. and J. J. Lim (2017), "Foreign Bank Behavior during Financial Crises". *Journal of Money, Credit and Banking*, 49, pp. 351–392. doi:10.1111/jmcb.12382,

[10] Temesvary J, and A. Banai, (2016) *The Drivers of Foreign Bank Lending in Central and Eastern Europe: The Roles of Parent, Subsidiary and Host Market Traits*.

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[12] De Marco, F., and M. Macchiavelli, (2016) "The Political Origin of Home Bias: the case of Europe", *Finance and Economics Discussion Series* 2016-060, Washington: Board of Governors of the Federal Reserve System. http://dx.doi.org/10.17016/FEDS.2016.060

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> THE NEW GOVERNMENT PUBLICLY ANNOUNCED THE END OF PRIVATIZATION AND QUESTIONS THE LOW NUMBER OF PRIVATIZATIONS MADE UNDER PREVIOUS GOVERNMENTS

RECENT TRENDS

It should be emphasized that the most important SOEs are controlled by the central government. Until March 31, 2017 such companies were managed by the Ministry of Treasury with few exceptions[18], but the new Law and Justice (PiS) government abolished this Ministry. Now, companies are directly under the prime minister or under relevant ministers.

Such a change is part of wider policy change after the elections won by PiS in 2015. The new government publicly announced the end of privatization and questions the low number of privatizations made under previous governments of Civic Platform (PO) and the Polish People's Party (PSL), which were in power during 2007–2015. Thus, periods 2007–2015 and 2015–2017 should be analyzed separately.

PRIVATIZATION IN 2007–2015

Privatization attempts by PO-PSL were half-hearted. Of 56 companies controlled by MoT with assets above PLN 1,000 million (EUR 235 million[19]), only three companies were fully privatized. However, the Ministry of Finance successfully privatized 735 smaller companies and the Ministry of Infrastructure restructured and initiated privatization of railway companies.

Despite the huge amounts of stocks sold by MoT in the largest companies, transactions were structured in such a way that MoT was able to retain control. Between 2008 and 2015, MoT received PLN 48.2 billion (EUR 11.4 billion) from the sale of shares in the 56 biggest companies, but MoT gave control to private investors in only three of them. To put it into perspective, the total revenue from privatization can be disaggregated into:

- PLN 31.57 billion (EUR 7.48 billion) from transactions in which MoT sold shares but remained the largest (controlling) shareholder;
- PLN 9.16 billion (EUR 2.17 billion) from transactions where SOEs bought shares of other SOEs;

[18] Like railway companies managed by the Ministry of Infrastructure.

[19] For simplicity of comparison, constant exchange rate of 4.22 PLN/EUR is used.

> OVERALL, THE PO-PSL COALITION GOVERNMENT PRIVATIZED MANY SMALL COMPANIES AND, THROUGH IPOs, BROUGHT MORE TRANSPARENCY INTO LARGER COMPANIES, BUT THEY STILL REMAINED UNDER THE STRONG CONTROL OF POLITICIANS

- PLN 5.56 billion (EUR 1.32 billion) disinvestment from companies in which MoT did not have control;

- PLN 1.91 billion (EUR 0.45 billion) genuine privatization (Ciech SA, Zespół Eletrowni Pątnów–Adamów–Konin SA, Polski Holding Farmaceutyczny SA).

In the case of smaller companies, greater progress was made: 573 companies were sold for PLN 8.35 billion (EUR 1.98 billion) and another 162 companies were transferred to local governments.

Moreover, the Ministry of Infrastructure followed the privatization agenda with regard to railway companies. During the 2012-2015 period, Polish Railways (PKP) sold non-core businesses (cable railway, energy, telecommunication, real estate) for PLN 1.9 billion (EUR 450 million). Also, Cargo company went through an Initial Public Offering (IPO) and, although PKP remained the main shareholder, the process brought more transparency into the company — not to mention PLN 2 billion (EUR 480 million) in revenue for the parent company. Revenues from privatization were used by PKP to deleverage.

Overall, the PO-PSL coalition government privatized many small companies and, through IPOs, brought more transparency into larger companies, but they still remained under the strong control of politicians. It should be also noted that besides its privatization effort, PO-PSL induced the state-controlled PZU to take over a private bank (Alior Bank).

PRIVATIZATION IN 2015–2017

The new Law and Justice government openly declared that no further privatization will be made and abolished the MoT, making relevant ministers responsible for controlling and developing SOEs in various sectors. Such a change induced infighting between ministers for the most valuable companies and their highly paid positions, so it is too early to know how a new control structure over SOEs will look like[20]. Although PiS publicly criticized privatization efforts of the previous government, until now no court rulings confirm the accusations of mismanagement by PO-PSL. The PiS government clearly continues a dangerous policy of the previous government of increasing public ownership in the banking sector. With government backing, government-controlled PZU has become a major shareholder in Pekao, the second-biggest Polish bank.

> THE PiS GOVERNMENT CLEARLY CONTINUES A DANGEROUS POLICY OF THE PREVIOUS GOVERNMENT OF INCREASING PUBLIC OWNERSHIP IN THE BANKING SECTOR

CONCLUSIONS

SOEs producing market output are overlooked by the most common measures of government size (general government expenditure to GDP, public consumption) that concentrate on general government only. In Poland, such omission gives a false vision of a relatively limited government when, in reality, SOEs play an important role in the Polish economy. Their relatively large size is further enhanced by the relatively small sector of large companies. As a result, one in six employees of large companies is working in an SOE.

Huge empirical evidence indicates that, on average, SOEs are less efficient than their private counterparts and their presence results in several market distortions, limiting the efficiency of the economy. Unfortunately, the current Polish Law and Justice government (as well as, to some extent, the previous one) are not only reluctant to privatize SOEs, but actively increase their market share at the expense of private sector. Over time, such a policy will lead to less efficiency and slower economic growth. •

[20] The most spectacular fight was between the minister of development and the minister of justice over PZU, the biggest Polish insurance company; in order to quell fights within the ruling party, the prime minister took direct control over the company.

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Municipal Energy Concepts: A Sustainable Model for Energy Transition or an Inefficient Distraction?

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STEFFEN HENTRICH

Energy transformation, Germany's plan to transform the energy industry into a greenhouse gas-neutral energy supply, is no longer solely a federal government project. Local authorities are beginning to push ahead with energy transition focused on decentralized municipal energy concepts.

> MANY GERMAN MUNICIPALITIES WISH TO UTILIZE THE EXPIRATION OF CONCESSION CONTRACTS FOR ELECTRICITY AND GAS SUPPLIES IN ORDER TO RE-COMMUNALIZE THE ENERGY SUPPLY

As many citizens have borne the cost of energy transformation so far, they would also like to profit from it economically. Terms such as "energy communities", "power self-sufficient municipalities", or "municipal energy transformation" are becoming popular. Many German municipalities wish to utilize the expiration of concession contracts for electricity and gas supplies in order to re-communalize the energy supply. Public utilities run by private operators are again coming under municipal ownership. In many places, energy cooperatives or citizens' wind parks are being established. So-called "tenant electricity models", in which the residents of a tenement house consume the electricity from a solar roof system themselves and are remunerated for surpluses fed into the electricity network are high on the agenda.

RATIONALE BEHIND ENERGY TRANSFORMATIONS

Motives for re-communalizing the energy industry are numerous. For many municipal politicians and citizens, the prospect of energy self-sufficiency, and more political and economic power, is attractive. Many municipalities intend to revitalize the economy and local labor markets with the regionalization and communalization of supply chains. With the takeover of the energy supply, municipalities hope to create a profitable business which will facilitate re-capitalization and cross-subsidization for municipal budgets.

> EVERY GERMAN FEDERAL STATE NOW HAS A CLIMATE PROTECTION PLAN

In addition to the commercial aspects, the implementation of individual climate protection plans also plays a role. Every German federal state now has a climate protection plan. Many municipalities are

> IT IS NOT POSSIBLE FOR A MUNICIPAL NETWORK OPERATOR TO INFLUENCE THE ELECTRICITY MIX OF THE MUNICIPALITY ACCORDING TO ECOLOGICAL CRITERIA

also setting specific targets for decreasing greenhouse gas emissions, intensifying the expansion of renewable energy sources, and increasing energy efficiency for heating supply as well as among local companies.

But how useful are those undertakings from the perspective of citizens? Are the municipalities actually gaining political power, or is there a risk that they might over-extend themselves? Could the resurgence of municipal involvement in the energy industry intensify competition? Finally, there is the question of the consequences of ecologically oriented re-communalization for the costs of energy transformation.

PROS AND CONS OF A COMMUNAL ENERGY SUPPLY

In the ideologically charged debate on energy supply as a basic public service, the answers to important questions come up short: Are municipal energy-economic activities suitable in realizing increased energy-political or financial room for maneuvering? Can they actually have an influence on sources of energy? Can municipalities generate sustainable profits? Do citizens really benefit from lower prices?

In most cases it is not taken into account that the energy policy framework for municipal activity in the energy industry has fundamentally changed over the last decades with the implementation of the EU Electricity Market Directive (EU Directive 2009/72/EC). Electricity market regulation requires a strict separation of electricity generation, the operation of transmission and distribution networks, and electricity distribution, which has considerable consequences for the utilization of municipal management options[1].

MUNICIPAL NETWORKS: HIGH INVESTMENT RISK, DUBIOUS ENVIRONMENTAL BENEFITS

Since the transmission of electricity cannot be refused by the network operator, it is not possible for a municipal network operator to influence the electricity mix of the municipality according to ecological criteria. The citizens decide by their choice of electricity supplier which energy sources are generated. In the case of interconnected networks, the selection of the energy source is limited for technical reasons and, therefore, a calculational reconciliation is utilized.

From an economic perspective, the operation of the electricity network entails considerable risks. The operation of distribution networks requires extremely specific know-how and experience.

[1] Schmidt, H. (2013) "Welche Vorteile kann ein landeseigenes Stadtwerk haben?", *Das Rathaus*, 2013(5).

> GIVEN THE PERSISTENTLY HIGH COST OF THE ENERGY TRANSFORMATION PROCESS IN GERMANY, THERE IS STILL STRONG POLITICAL PRESSURE TO REDUCE THE SCOPE OF SUBSIDIES AND PRIVILEGES OF SUBSIDIZED FACILITIES

New technological territory must be approached regarding the grid integration of fluctuating electricity producers (photovoltaics, wind power) and the construction of an intelligent electricity grid (smart grid). That requires additional, previously difficult-to-predict investments, which over the years burden the public funds of the municipalities. Those costs cannot simply be transferred to network users because the returns and revenues are limited by regulation. The local authorities' prospects for permanently high revenues from network operations are therefore very uncertain.

MUNICIPAL POWER GENERATION: INVESTMENT RISK ENERGY POLICY

In the area of power generation, on the other hand, municipalities can operate successfully. However, whether long-term investment in renewable energy will pay off depends on the federal government's future funding policy.

According to the Renewable Energy Law (EEG), electricity from renewable sources is preferentially fed into the electricity grid and the producers are guaranteed a fixed feed-in compensation. Up to now, German plant operators have been able to assume that the EEG grant would not pose any major business risk. That has changed since the January 2017 EEG reform. Instead of benefiting from state-established feed-in compensation, plant operators over a certain capacity threshold now have to compete for the amount of remuneration.

Only the most economic projects with the lowest remuneration demands are being supported and approved for grants. As a result, prospects for secure project profits have deteriorated. Given the persistently high cost of the energy transformation process in Germany, there is still strong political pressure to reduce the scope of subsidies and privileges of subsidized facilities. Despite guarantees for existing installations, additional charges for the networks and storage facilities or additional technical requirements could affect yields and even cause considerable losses for municipal operators in the medium term.

However, it is not only the instability of the energy policy framework and the constantly changing funding conditions that are a problem for plant operation. The risk of investment is also high because of the unreliability of forecasts for wind and sun.

> LITTLE EVIDENCE EXISTS THAT ADDITIONAL MUNICIPAL INVESTMENT IN POWER PLANTS IS IMPERATIVE FOR COMPETITION IN THE ELECTRICITY MARKET

An empirical study of the profitability of more than 175 wind parks in citizens' projects over a 10-year period drew a sobering conclusion: In 82% of the wind parks, revenues were below projected results, with the result that the dividend paid to investors was only about 1/3 of the value promised in the investor prospectus. The reasons were overly optimistic wind forecasts and too low estimates of operating costs[2].

MUNICIPAL COMPETITION: LOW COMPETITION RESTRICTIONS IN THE ELECTRICITY MARKET

It is often argued that municipal power generators would be necessary to break the market power of large electricity companies. The market share from conventional power generation capacities of the four major German power utilities (RWE, E.ON, Vattenfall Europe, and EnBW) is a high 62%. According to the argument, that enables them to abuse their market power more than a decade after electricity market liberalization. Proponents of recommunalisation claim that fair competition could only be achieved by more decentralized energy providers directly controlled by municipalities or citizens.

The German Monopolies Commission dealt more extensively with the issue of market power of the four large energy suppliers in the electricity wholesale trade in 2015[3]. In their expert opinion, they noted that competition in the electricity market had intensified significantly over previous years and no striking market power problems existed.

Throughout 2014, no single hour could be determined in which one of the big four energy suppliers could meet the electricity demand alone. It is only under this condition that the capacity of a single supplier would be system-relevant and could increase the price because it could no longer be surpassed by other market providers.

Therefore, it can no longer be assumed that the large nationwide energy supply companies have individual market power, and thus, pricing power. The incentives for capacity constraints of individual suppliers would also be relatively low in view of high over-capacities and the generally low price level in electricity wholesale. Accordingly, little evidence exists that additional municipal investment in power plants is imperative for competition in the electricity market.

LOCAL ELECTRICITY DISTRIBUTION: LIGHT AND SHADOW FOR CITIZENS

For a municipality, electricity distribution can be an interesting source of income with low entry barriers. With professional management, relatively acceptable returns can be achieved with comparatively low investments.

> THE EXPERTS CAME TO THE CONCLUSION THAT MORE LOCAL VENDORS DO NOT NECESSARILY MEAN LOWER ENERGY PRICES FOR CUSTOMERS

Nonetheless, there are strict limits when it comes to intentions to finance acceptable energy prices and municipal tasks from the profits. An internal subsidization of non-cost pricing would require above-average revenue from contracts with customers who are willing to pay. Since they have the opportunity to switch to the most inexpensive provider on the deregulated electricity market in Germany, there is little scope for generating excess profits by price setting.

For a citizen, the municipal energy provider is not necessarily the best choice. Energy utilities under municipal sponsorship have not necessarily proved to be the cheapest providers in the past.

In an empirical survey of retail prices in the energy market, the Monopoly Commission found that municipal providers only offered the cheapest rate without advance payment in 1% of all observed cases in various postal areas[4]. Only when the local provider acted as the basic provider was their average offer marginally cheaper than the big four and other private energy suppliers. The price was, however, still 28% above the average price of the first-place provider. Overall, the experts came to the conclusion that more local vendors do not necessarily mean lower energy prices for customers.

> BECAUSE PLANTS ARE INCREASINGLY BEING PURCHASED ON THE WORLD MARKET AND RUN BY NATIONALLY OPERATING SPECIALIST COMPANIES, THERE IS NO GUARANTEE THAT THE LION'S SHARE OF ADDED VALUE GENERATED IS RETURNED TO THE COMMUNITY

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[2] Daldorf, W. et al. (2013) Praxiserfahrungen mit der Wirtschaftlichkeit von Bürgerwindparks in Deutschland. http://www.energieagentur-goettingen.de/fileadmin/files/downloads/130213_Daldorf_Praxiserfahrungen_mit_BA__1_4rgerwindparks.pdf

[3] Monopolkommission, 2015. Energie 2015: Ein wettbewerbliches Marktdesign für die Energiewende, http://www.monopolkommission.de/images/PDF/SG/s71_volltext.pdf

[4] Monopolkommission (2011) *Energie 2011: Wettbewerbsentwicklung mit Licht und Schatten*, Bonn: Monopolkommission. http://www.monopolkommission.de/index.php/de/gutachten/sondergutachten/242-sondergutachten-59

MUNICIPAL ADDED VALUE AND JOBS

New sources of tax revenue, the creation of additional jobs, and strengthening the purchasing power of the regions are cited as arguments for the municipalization of the energy supply. The problem with this perspective is both the one-sided perspective regarding the drivers of local economic power and ignorance of the economic consequences.

Municipal added value is often quantified as the sum of the profits of local enterprises, the income of their employees, and the taxes paid by both. A distinction is usually made between the one-off effects related to investment and subsequent disposal of energy plants, and the annual recurring value during operation. There is the hope that as much of the investment as possible will be put into the hands of municipal enterprises and traders. Municipal policymakers continue to focus on the performance of the local economy.

However, because plants are increasingly being purchased on the world market and run by nationally operating specialist companies, there is no guarantee that the lion's share of added value generated is returned to the community. In the maintenance and operation of facilities, nationwide service providers are also often used for cost reasons.

Regularly overlooked is the downside of value creation from municipal investments which involve a commitment of scarce financial resources. Investment funding for local energy projects is no longer available for other projects, such as social or educational programs. Scarce municipal finances require the highest possible efficiency in their deployment. In the context of existing investment and operating risks related

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> FOR THE LONG-TERM ECONOMIC STRENGTH OF A MUNICIPALITY, IT IS NOT ESSENTIAL THAT MANY ECONOMIC ACTIVITIES ARE CONCENTRATED IN PUBLIC FUNDS

to local energy projects, it is uncertain whether returns can compensate for the shortcomings in other public services.

In addition, an alternative use of investment and resources could also mean added municipal value, jobs, and tax revenue. The focus on energy projects merely involves a redistribution of resources. Ultimately, it should be clear that local investment and employment represent business costs. Only after several years will it be possible to determine whether the balance of a municipal investment is positive and whether redistribution measures have paid off.

For the long-term economic strength of a municipality, it is not essential that many economic activities are concentrated in public funds. Instead, a framework is needed within which trade and companies can specialize in the production of goods and services with a cost advantage over other locations. A locally financed, inefficient

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> MANY MUNICIPAL ENERGY FACILITIES ARE ONLY ECONOMICALLY SUSTAINABLE THROUGH GOVERNMENT SUBSIDIES WHICH ARE FINANCED BY CONSUMERS, THROUGH A LEVY ON ELECTRICITY PRICES, OR WITH TAXES

economy is at best a flash in the pan and causes a loss of economic power in the long term.

MUNICIPALIZED BENEFITS, SOCIALIZED COSTS

Many municipal energy facilities are only economically sustainable through government subsidies which are financed by consumers, through a levy on electricity prices, or with taxes. Uneconomic energy production from renewable energy sources is worthwhile for the citizens of a municipality merely due to the redistribution of subsidy-costs among all energy consumers in Germany. Grid operators uniformly pass on the difference between EEG payments and the proceeds from stock sales of EEG energy to energy consumers. The EEG levy for remaining consumers increases due to the partial exemption of energy-intensive businesses and existing special arrangements for private consumption.

The same applies to CHP plants as long as their cost-effectiveness is dependent on remuneration under the Act on Combined Heat and Power Generation (KWKG). Within the last 10 years, the levy of EEG subsidy on the price of electricity has risen more than six-fold from 1.03 ct/kWh to 6.88 ct/kWh. Every federal citizen now pays around EUR 300 per year for the subsidizing of renewable energy sources[5].

Additional costs for network integration have not yet been taken into account. With the steady increase of privileged power supplies from volatile wind turbines and photovoltaic systems, and increased spending on the stabilization of electric power networks and expansion and reinforcement of electricity network costs, there has been a significant increase in network charges.

After the average network charges were reduced through regulation, they have risen significantly since 2012. In network areas with highly volatile power generation, network charges on the price of electricity have been particularly high[6]. An assessment by the Düsseldorf Institute for Competitive Economics (DICE) on behalf of the Initiative for New Social Market Economy (INSM) estimates the total cost of energy

[5] BDEW (2017) *Erneuerbare Energien und das EEG: Zahlen, Fakten, Grafiken*, Berlin. www.bdew.de

[6] Bundesnetzagentur (2017) *Netzentgelt, Was ist ein Netzentgelt (auch als Netznutzungsentgelt Bezeichnet)?* https://www.bundesnetzagentur.de/SharedDocs/FAQs/DE/Sachgebiete/Energie/Verbraucher/Energielexikon/Netzentgelt.html;jsessionid=CCA60A737395768FA91F1CA882D6EC56?nn=266668

> THE EEG LEVY HAS CAUSED SUBSTANTIAL PAYMENT STREAMS AMONG THE GERMAN FEDERAL STATES

transition at EUR 520 billion by 2025, which totals EUR 25,000 for a four-person family (Haucap et.al. 2016)[7].

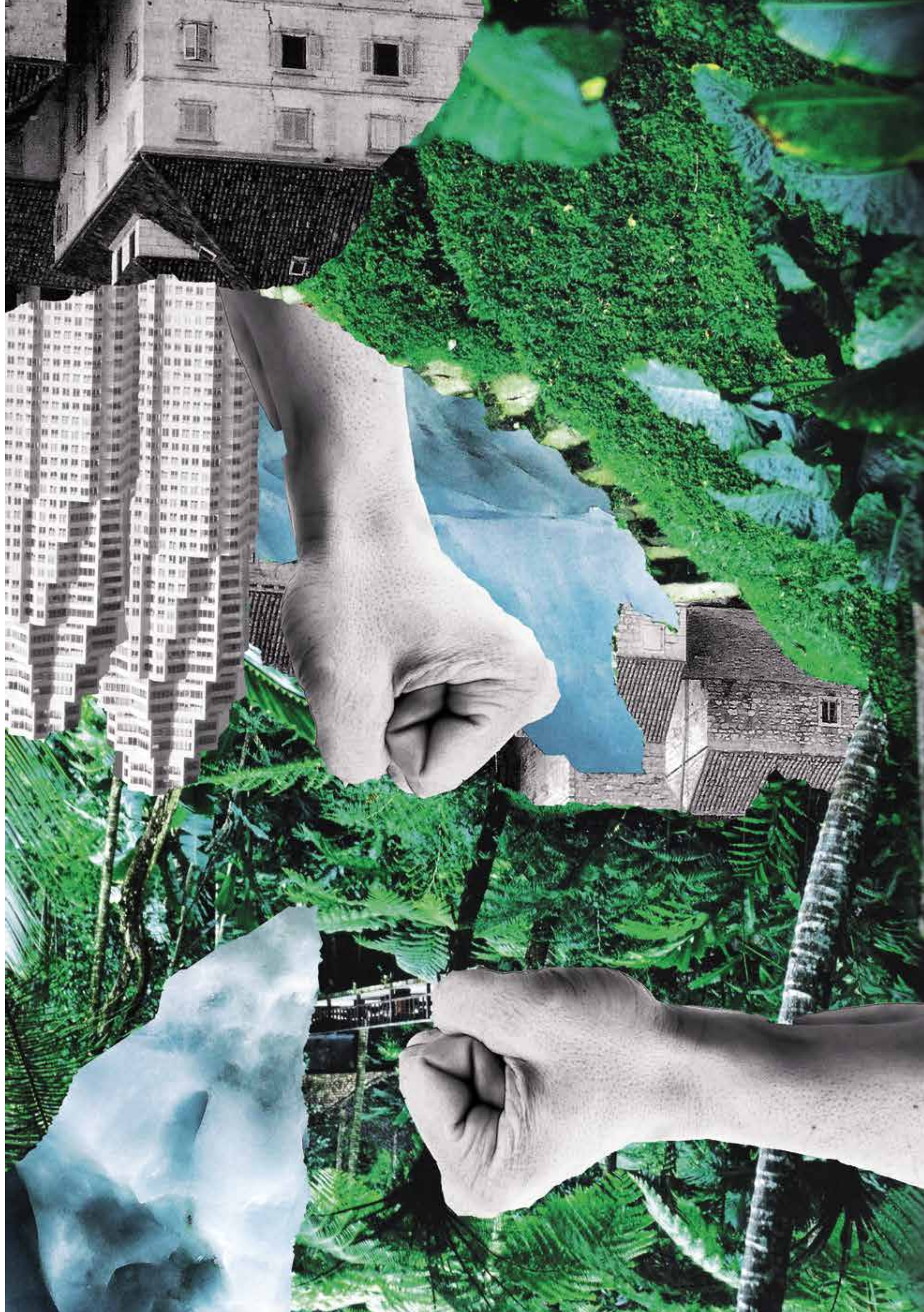
The EEG levy has caused substantial payment streams among the German federal states. States with high energy consumption relative to the energy production of EEG-supported systems pay to federal states where little energy is consumed relative to energy production from renewable energy sources.

In its 2013 annual report on the development of renewable energy in Germany, the Federal Association of Energy and Water management e.V. (BDEW) determined the level of a hypothetical EEG levy, which would be required if each state would only foster its "own" EEG facilities.

In federal states with strong winds but low populations (and therefore low consumption) such as Mecklenburg-Vorpommern, Schleswig-Holstein, Saxony-Anhalt, and Brandenburg, consumers in 2014 would have had to pay a renewable energy levy significantly over 10 ct/kWh, and in Mecklenburg-Vorpommern over 20 ct/kWh given its low power consumption. In Bavaria, with its abundant energy from solar power and biomass, the hypothetical renewable energy levy because of high consumption in the state would have been 7.9 ct/kWh, but this level would still have been higher than the then-valid nationwide level of 6.17 ct/kWh[8].

Owing to the sustained growth of new facilities, those discrepancies are likely to have increased further. Individual municipalities would have to charge far higher surcharges on electricity prices so that municipal electricity generation pays off. The gains in purchasing power made by local and regional economies would be quickly used up by the cost burden of energy consumers in the majority of cases if not for the nationwide redistribution effect of the EEG reallocation charge.

As a rule, the immediate negative consequences of the municipal expansion of renewable energies are often overlooked. Wind turbines damage the landscape, as do large-scale photovoltaic systems. The cultivation of biomass can negatively affect the diversity of flora and fauna. The necessity for grid connections from power plants creates anxiety among the population over the construction of high-voltage power lines. The local quality of life suffers, as does the attractiveness of the municipality for tourism.



[7] Haucap, J., Loebert, I. , and S. Thorwarth (2016) *Kosten der Energiewende, Untersuchung der Energiewendekosten im Bereich der Stromerzeugung in den Jahren 2000 bis 2025 in Deutschland*, Düsseldorf. http://www.insm.de/insm/Themen/Soziale-Marktwirtschaft/Gesamtkosten-Energiewende.html

[8] BDEW (2015) *Erneuerbare Energien und das EEG: Zahlen, Fakten, Grafiken*, Berlin. https://www.bdew.de/internet.nsf/id/20150511-o-energie-info-erneuerbare-energien-und-das-eeg-zahlen-fakten-grafiken-2015-de/$file/Energie-Info_Erneuerbare_Energien_und_das_EEG_2015_11.05.2015_final.pdf

A SHORT HISTORY OF POWER PROVISION IN GERMANY

With the discovery of the dynamo principle by Werner von Siemens began the triumph of electricity from 1866 onwards. At the beginning, every power consumer produced their own electricity. Starting in 1884, the first municipal electricity utilities were built in Germany to supply households and businesses. Their supply networks were mostly operated with direct current and were therefore limited to a very small radius around the power station.

To supply power to rural areas, so-called intercity centers were created, which enabled a comprehensive supply of alternating current. Later, regional suppliers emerged. The majority of electricity companies were owned by the public authorities or were mixed-economy enterprises. That reflected the strong public interest in safe and inexpensive power supply. After the First World War, the networks of regional suppliers were linked to the whole country.

Despite the dominance of the public sector, the electricity industry initially developed under private competition. No state privileges were granted to the companies. Supply areas were the result of the technical peculiarities of the power supply. Distribution and transport networks were largely subject to the conditions of a natural monopoly. Network monopolies were secured by concession contracts and demarcation contracts. During the Nazi era, the power supply was regulated under state supervision by the Energy Industry Law. Soon after, a tariff classification led to the harmonization of consumer prices for electricity. In 1957, the Restriction of Competition Act continued to exempt territorial protection agreements from the prohibition of cartels.

As a result, a three-stage system of public power provision developed in Germany: Affiliated companies produced electricity in large quantities, operated the transmission network and were responsible for frequency stability. Regional suppliers organized the nationwide distribution. Municipalities then distributed the electricity to the final customers.

Only the liberalization of the electricity market in 1998 abolished the permissibility of demarcation contracts and exclusive concession contracts. The liberalization of the electricity industry was initiated by the EU Internal Market Directive 96/92/EC. From then on, network operators were obliged to provide their networks to other power suppliers for the supply of customers. Their aim was to create a European single market for electricity and to strengthen competition in the electricity market.

With the 2005 amendment to the Energy Industry Law, all electricity consumers had the opportunity to change their electricity provider. In addition, the negotiated network access was replaced by an unbundling of production, transport, and distribution of electricity. To this end, a regulatory authority for network access regulation had to be created in Germany. It is responsible for the incentive regulation of network charges. With the third EU single market package, the transmission grids had to be separated from production and trade. Since then, there are four transmission network operators in Germany.

With the liberalization of the electricity industry, the course for intensive competition, production, and trade of electricity was set. That also offers new business opportunities for decentralized municipal energy suppliers.

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Also, real estate assets of the population can suffer losses when wind farms or other power facilities are built nearby. The resulting losses affect not only citizens in the investing municipalities, but also the communities in the vicinity. Meanwhile, several federal states have responded to resistance among their populations and increased the minimum distance of wind farms from residential areas by up to 10 times the height of the facility.

Given the current legal situation, individual federal states and municipalities have an incentive to achieve maximum yield from the redistribution mechanism. Macroeconomic interest in a low-cost realization of energy transformation and the corresponding climate protection goals are thus pushed into the background. The end results are inefficient investment decisions and persistently high costs for all energy consumers.

COMPETITION IN THE ENERGY MARKET AS THE BEST PUBLIC SERVICE

Municipal energy generation can contribute to a sustainable, healthy, economic structure and long-lasting, secure employment in a region only if it is profitable without government subsidies and guarantees a secure and affordable energy supply for citizens and businesses. In power generation and distribution, a municipality can only survive the competition if projects are solidly planned, financed, and professionally managed. However, the question is whether it would not be better for municipalities to abandon their own entrepreneurial initiatives in favor of competitive placement of clearly specified public service tasks to private companies.

If the business model of local authorities and private investors involved in municipal utilities is based solely on government grants and the nationwide levies from the EEG or the KWKG, it ties the players into a dangerous dependency on state transfers and energy policy privileges. That does not allow for stable investment conditions for the economy in the long term, and is a burden on citizens should ambitious return expectations not be fulfilled.

To what extent regional interests have already been affected by the necessary reforms in energy transformation is shown by the actions of state representatives in Germany's Federal Council (Bundesrat). In the past, changes to EEG remuneration rates and power regulations have been repeatedly delayed by the Federal Council.

For the majority of electricity consumers and taxpayers, subsidized energy projects are a burden which become greater the more local politicians and private-sector interest groups exert their political influence. So far, the energy policy framework has almost invited municipal energy projects to proverbially cut the ground from under each other's feet. ●

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Fighting Fire with Fire: Employing Regulation Against Government


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ŽILVINAS ŠILĖNAS

After the dissolution of communism in Eastern Europe, most state-held property was transferred to private ownership. That effectively ended the ownership of means of production by the state and destroyed the foundations on which communism stood. While privatization varied in time and scope in different countries, the basic idea was to never return to state-owned bakeries, petrol stations, or restaurants.

> IT SEEMS THAT SOEs ARE HERE TO STAY FOR A LONG TIME.

While some companies remained state-owned, in the spirit of privatization, it seemed just a matter of time until all state-owned enterprises (SOEs) were private. Remaining holdouts (energy companies, railways, and other "strategic assets") it was thought by some, would be privatized later. That in fact was the agenda of some governments for at least a couple decades.

However, the political climate changed and the enthusiasm for privatization died down. The 2008 financial crisis, geopolitical tensions, and other macro factors have slowed down SOE privatization. In some CEE countries, the trend has even reversed. Estonia nationalized its railways in 2007 and Lithuania bought out private investors in its energy companies. Far from being on a transition to privatization, it seems that SOEs are here to stay for a long time.

This puts free marketeers in a peculiar position. Our best solution is, of course, to privatize SOEs. But if privatization is out of the political agenda, what is the second-best solution? Make SOEs adhere to the same set of rules as private companies, lose the privileges they have, or be run like private businesses?

STATE-OWNED ENTERPRISES – A RECURRING HEADACHE

The fundamental problem is that the state retains ownership of the means of production – just like in the Soviet times. However, some more dangerous problems loom when the state retains ownership of large companies. Lost revenue, industry politicization, handing out well-paying jobs to party loyalists, sub-optimal pricing, cross subsidization – all are a reason for concern.

> WHEN GOVERNMENT CREATES RULES AND MUST ABIDE BY THEM, IT IS NOT UNUSUAL FOR GOVERNMENTS TO CHANGE THE RULES SO SOEs CAN PROCEED

It is equally dangerous if SOEs go on the offensive to expand their operations. First, it is not unfathomable that during the times of uncertainty SOEs can be better-placed to invest or expand into new sectors of economy compared to private investors. Bureaucratic burdens, taxation, and regulation all create large obstacles for private businesses. But SOEs can easily bear them or avoid them. When government creates rules and must abide by them, it is not unusual for governments to change the rules so SOEs can proceed. It is called "corruption" if such favors are handed to private companies, but "public interest" if SOEs are involved.

> IF SOEs ARE HERE TO STAY, WE NEED SOME SORT OF REGULATORY RESPONSE THAT LIMITS THEIR EXPANSION AND MITIGATES THE DAMAGE THEY CAUSE

Second, we should not forget that rich SOEs could attract high-quality people or outcompete private sector for talent. Capable managers tasked with increasing the value of SOEs see no qualms in expanding SOE operations. Pair talent with deep pockets and flexible rules, and SOEs can truly push private companies out of the market.

If SOEs are here to stay, we need some sort of regulatory response that limits their expansion and mitigates the damage they cause. But we also need a *casus belli* to show that expanding SOEs are a problem, one that can be tackled with regulation.

Of course, free marketeers have an abundance of arguments against SOEs *per se*. However, in the changing political climate, they would not suffice. Liberal arguments and evidence are very powerful for people who subscribe to or sympathize with liberal ideology. But if a new political consensus sees no problem with the government owning the means of production, those arguments would not do.

So, let us re-explore the notion of government failure and regulatory capture. After all, if governments justify intervention into markets because markets are imperfect, could we not adopt similar arguments in relation to SOEs? If regulatory capture is possible (and even the critics of liberalism agree that it is), would SOEs not be guilty of that as well? Would it not be something that governments should address?

REGULATORY CAPTURE, GOVERNMENT FAILURE

Because the government is the agency that sets up and enforces regulations, it has the ability to create an uneven regulatory playing field. As critics of capitalism like to point out, it can happen even without the involvement (or existence) of SOEs. Private enterprises are also susceptible to engaging in regulatory capture, attempts to subvert regulation to favor certain enterprises or business models.

If private companies engage in regulatory capture, there remains a possibility for it to be discovered and dismantled. Since non-neutral regulations favoring certain private enterprises produce losers and winners, the losers have the incentive to expose capture and show how certain companies profit from it. If regulation is exposed and recognized as unfairly benefiting certain private actors, there is a large chance that this will be recognized as "unfair" and regulatory capture – dismantled.

> IF CERTAIN SECTORS OF THE ECONOMY HAVE BEEN DOMINATED BY THE STATE, IT IS LIKELY THAT PROFESSIONALS, RESEARCHERS, OR EVEN ACADEMICS ARE CONNECTED TO THE SOEs

But if we have a situation where SOEs are involved, and especially where SOEs receive preferential treatment vis-à-vis private ones, the chances of undoing the regulatory capture are reduced.

First, the public and the politicians might not even recognize the existence of capture. Preferential treatment to SOEs might be explained as a natural feature arising from regulating a complex sector of the economy, where absolutely equal treatment is technically impossible.

If we accept that regulatory failure arises because industry players can hire better talent than the regulators, this certainly works in the case of SOEs. In fact, if SOEs are not experiencing pressure from shareholders to produce profit (which is often the case), they can afford to spend more resources on hiring the best talent to argue with regulators and influence politicians and decision-makers.

Even more, if SOEs dominate or have been dominating a certain sector of the economy (e.g., energy), smaller countries might lack talent for the regulators to hire. If certain sectors of the economy have been dominated by the state, it is likely that professionals, researchers, or even academics are connected to the SOEs. They do not need to be working for the SOE or benefiting from it in any way. But due to the long-term dominance of the sector by SOEs, professionals and academia might come to believe that SOEs *are* the proper way to run the sector. That is especially prevalent in sectors that have a degree of technological sophistication or where very few people have had direct experience in the sector. To rephrase Hayek, there is a true "knowledge problem" here: few people know how to run a sector, and those who do believe that the government should run it.

Second, even if regulatory capture is recognized and it is acknowledged that an SOE is receiving preferential treatment, many politicians or regulators might not

Example 1. Independent producers of energy in district heating system in Lithuania

A large portion of houses in Lithuania are heated by a district heating system (DHS). After reforms in 1997, DHS was decoupled from the gas and electricity sectors. After the reform, each DH company produced energy and supplied it via district heating pipelines to consumers as a vertically integrated company. After 2003, the two activities were unbundled into energy production and energy supply. Supplying energy in DHS via pipelines remained a market with barely any competition. Most DHS supply networks remained municipality-owned; moreover, companies with DHS supply networks also retained energy production facilities (power plants) and remained vertically integrated companies.

However, energy production became a competitive market where different independent producers of energy could produce energy and sell it to the DH company to be delivered to consumers. To open up the market, a regulation was imposed that stated DH companies have to purchase energy produced by independent producers if the independent producer offers energy for a price smaller than the variable cost of energy production in the power plant of a vertically integrated DH company.

On one hand, the integrated DHS company is forced to purchase energy from its competitors. On the other hand, it has to purchase it only if the competitor is able to produce energy for less. The problem arises in how the rule is set up. If independent producers want their energy bought, they have to offer the price, which is not only lower than the energy production cost of the integrated DH company. Instead, the price charged by the independent producer has to be lower than the variable cost of the DHS company.

To put it simply, in order to stay in business, independent producers have to be so efficient that their fixed (capital) costs and variable (fuel) costs are lower than variable (fuel) costs of incumbent DHS companies. The playing field is uneven, yet this practice remains. Moreover, many decision-makers feel that this system is "as good as it gets" or even too generous to independent producers.

The discussions regarding this issue touches upon nearly all the possibilities mentioned in the article. Some decision-makers think this system is as fair as it could get due to the nature of the sector. Others believe that DHS supply companies have to have certain advantages because they are tasked with being a "supplier of last resort". Yet others think that liberalization and opening of the market was a mistake, and hope that this regulation will drive independent private producers out of the market, making the DHS entirely owned and operated by the government.

> IT IS NOT UNHEARD OF TO APPLY ONE SET OF RULES TO "FOR-PROFIT" COMPANIES AND ANOTHER SET OF RULES TO "NOT-FOR-PROFIT" COMPANIES

see it as an issue. Under the guise that SOEs are there for purposes other than profit, the necessity to apply the same rules to all enterprises might not be evident. It is not unheard of to apply one set of rules to "for-profit" companies and another set of rules to "not-for-profit" companies. The tendency does not even have to be stated explicitly to have implicit consequences for the thought processes of politicians, regulators, journalists, or even judges.

To put it simply, SOEs are very capable of convincing decision makers that they are in business not to earn profit, but for some "higher purpose". Therefore, preferential treatment vis-à-vis private enterprises (which, of course, are in the "for-profit" business and nothing else) is natural, unavoidable, and justifiable (some politicians and regulators might not even need convincing, since this is exactly what they believe in anyway).

Third, even if cases where regulatory capture is identified and recognized as a problem, regulators and politicians might still choose to continue the practice [See Example 1]. Quite often, SOEs are tasked with many politically motivated functions (e.g., to provide very cheap transportation services). SOEs can convince poiticians that giving preferential treatment to SOEs vis-a-vis private enterprises is natural, unavoidable, and justifiable. And, of course, some politicians and regulators might not even need convincing, since this is exactly what they believe in anyway [See Example 1].

> THE IDEAL SOLUTION TO PREVENT SOEs FROM EXPANDING WOULD BE TO PERSUADE THEIR SHAREHOLDERS (THE GOVERNMENT) ABOUT THE DANGERS OF EXPANSION AND HAVE THE SOEs DISMANTLED AND PRIVATIZED

PUBLIC
ENTRANCE
GPO
ENTRANCE

Example 2. A questionnaire to help assess whether new regulation has an impact on competition

Does regulation affect market entry *directly*? There is a high probability that it does, if the regulation:
- Grants special or exclusive right to a company;
- Orders to purchase a product from a single company or a set group of companies;
- Creates a new licensing procedure or any other mandatory procedure that is necessary for companies to start operation;
- Fixes or caps the number of market participants.

Does regulation affect market entry *indirectly*? There is a high probability that it does, if the regulation significantly increases:
- Market entry costs for companies trying to enter the market;
- Market exit costs for companies trying to enter the market.

Would the new regulation affect the *abilities* of companies to compete? It is likely if regulation:
- Limits whether companies can decide on prices for their own products;
- Sets arbitrary requirement for products; or
- Increases the costs of some companies operating in the market;
- Limits method of sale or place of sale; or
- Limits advertising of products.

Would the new regulation affect the *incentives* of companies to compete? It is likely if regulation:
- Requires or encourages to publish information about costs, prices, volumes of sales, and production; or
- Exempts certain companies or sectors from observing rules of competition; or
- Increases costs for consumers who wish to select or switch suppliers; or
- Sets or changes the regime of intellectual property.

If you have answered NO to all questions, it is very unlikely that the proposed regulation would affect competition.

If you have answered YES to any single question, it is necessary to evaluate alternatives and select the one with least or no effect on competition

Source: Competition Council of Republic of Lithuania http://www.kt.gov.lt/uploads/documents/files/veiklos-sritys/viesieji-pirkimai/klausimynai/Kaip_vertinimo_klausimynas.pdf

If government chooses to regulate a sector of the economy, there is a risk that regulation will be captured and exploited to curb competition. If regulatory capture is done by SOEs, the risks are much higher. SOEs can be better positioned to perform capture, and politicians, regulators, and other agencies tasked with prevention of regulatory capture might choose not to act to prevent or dismantle the capture.

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ARTICLE 4 OF THE LAW OF COMPETITIONS STATES THAT GOVERNMENT AGENCIES CANNOT ISSUE REGULATIONS THAT WOULD DISTORT COMPETITION, DISCRIMINATE, OR FAVOR CERTAIN ENTERPRISES VIS-À-VIS OTHER ENTERPRISES

HOW CAN SOE EXPANSION BE CURBED?

Obviously, the ideal solution to prevent SOEs from expanding would be to persuade their shareholders (the government) about the dangers of expansion and have the SOEs dismantled and privatized. As this explicit solution is not usually an option, we have to look for second-best, indirect solutions to the problem. Lithuania provides several interesting case studies.

1. Prohibit discrimination and even instead of neven

Article 4 of the Law of Competitions states that government agencies cannot issue regulations that would distort competition, discriminate, or favor certain enterprises vis-à-vis other enterprises. Therefore, ministries, municipalities, and other government agencies are prohibited from favoring any enterprises, including SOEs. To put it simply, if the government created a government-run taxi company and ordered all public-sector departments to purchase taxi services only from this company, such a regulation would be a direct violation of Article 4 and void.

Of course, Article 4 has its limits. It cannot cancel laws passed by the Parliament. Continuing the taxi company example, if Parliament passed a law which stipulated the creation of said company and obliged public-sector department to purchase taxi services only from this company, Article 4 would be powerless. However, if that were the case, one could invoke Article 46 of the Republic of Lithuania, which stipulates that the economy of Lithuania is based on private property and monopolizing a market is prohibited.

Therefore, Article 4 serves to prevent ministries, regulatory agencies, and local governments from creating an uneven playing field. The article cannot prevent it if the

> IF SOEs ARE ALLOWED TO PURCHASE GOODS AND SERVICES FROM THEIR SUBSIDIARIES WITHOUT OPEN TENDER PROCEDURES, THERE IS A RISK THAT MANY OF THE SUBSIDIARIES ARE PROPPED UP BY SOEs TO CONTINUE OPERATING SUB-EFFICIENT BUSINESSES AT THE EXPENSE OF THE TAXPAYER AND COMPETITION

government is intent on distorting the market and has the political influence to pass the law in Parliament. However, it constitutes a rapid response option (especially compared to the Constitutional Court). If it were not for this regulation, many public agencies would get away with violations simply because the court system is slow and cases can drag on for years.

The Competition Council of Lithuania is also engaged in prevention work. Their questionnaire [See Example 2] is designed to help decision-makers quickly evaluate whether their proposed regulations or rules would affect competition. Moreover, it encourages selecting alternatives with the least impact on competition.

Article 4 has been invoked multiple times. It serves as a preventative measure to dissuade politicians from passing bad legislation, and as a tool to cancel regulations that have been passed. And yes, it has been used to dismantle a government-run taxi company in 2014 [See Example 2].

2. Prohibit purchases without open tenders

A new amendment to the law on public procurement forbade SOEs from contracting their subsidiary companies without an open public tender. That means that SOEs cannot purchase goods or services from companies they own without an open public auction in which independent contractors are also allowed to participate. Furthermore, if an independent contractor offers a lower price (or a better value), SOEs are obliged to award the contract to the independent contractor, not their own subsidiary. However, municipality-owned enterprises are exempt from this obligation.

How is this amendment helpful? First, some large SOEs have a history of insourcing, rather than outsourcing, various services. For example, the national railway carrier of Lithuania (Lithuanian Railways) manages infrastructure and runs freight and passenger services, and also has subsidiary companies for building and repairing railway tracks, servicing engines, providing security, cleaning, and environmental protection services, renting *road* cargo vehicles and agricultural machinery, planting trees, and selling firewood. If SOEs are allowed to purchase goods and services from their subsidiaries without open tender procedures, there is a risk that many of the subsidiaries are propped up by SOEs to continue operating sub-efficient businesses at the expense of the taxpayer and competition.

Second, many of the subsidiary services have nothing to do with the rationale given when governments chose to retain ownership in SOEs. To put it simply, one can understand (and disapprove) when the government claims to retain ownership of railways for “strategic” or “security” reasons. However, there is nothing “strategic” about a SOE owning a subsidiary that sells firewood. Speaking in terms of what is politically feasible, it might be difficult to persuade the government to privatize the railways. But it is much easier to convince the public and politicians that the government has no business running a company that sells firewood.

Third, this prohibition has a couple of potential positive outcomes. If non-essential subsidiaries are inefficient and have been propped up by a parent SOE, the requirement to go into open tenders could push them out of the market and into bankruptcy. That would then open possibilities of liquidating the companies, privatizing them, or closing them down. In one way or another, the objective of reducing direct participation of the government in the economy would be achieved.

If, on the other hand, the subsidiaries survive competition enabled by open tenders, it might result in lower prices and higher operating efficiency of a SOE. Transparency created by open tender procedures also create possibilities to inquire whether the subsidiary is playing on a level playing field in terms of regulation or whether it receives subsidies from the parent company. Regardless of how one looks at it, destroying the possibility for parent SOEs to purchase products from its subsidiary without any competition, publicity, and at inflated prices greatly reduces the ability for SOEs to finance subsidiaries in other sectors of the economy.

That type of regulation could be expanded as widely as possible, covering SOEs and also municipality-owned enterprises (MOEs) or even public bodies. If the law on public procurement applies to any agency spending taxpayers’ money, there is a possibility to apply and extend this regulation.

Of course, one could argue that this is not a free-market solution, or that there is nothing inherently wrong with companies purchasing products from their subsidiaries at inflated prices. Or that private companies do it all the time. The critique is correct. However, given the realities of politics and the extent to which some SOEs abuse the system and the challenges posed, it might be a worthy policy choice.

3. Prohibit easy expansion into other sectors of the economy

If the previous part dealt with what to do with SOEs that have expanded into other sectors of the economy, this part will highlight a possible counter-measure to prevent expansion. As an old dictum goes, “prevention is better than cure”.

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IF, IN THE LONG RUN, THINGS TURN SOUR AND GOVERNMENTS CONTINUE THEIR MARCH INTO THE ECONOMY, WORKING ON LEGAL BARRIERS TO CURB THE GOVERNMENT IS A WORTHY AND TIMELY INVESTMENT

An amendment to the law of local governance passed in 2016 stated that if a local government (municipality) wanted to create government-owned companies (or expand existing ones), it had to prove to the Competition Council that establishing a new government-owned company was the only way to achieve the necessary public policy objectives. If a city decided to create a government-owned taxi company, it would have to prove that it had exhausted all other possibilities to provide public transportation.

Of course, this rule is not foolproof. However, it provides a legal barrier, a type of legislative roadblock to prevent fast developments. What is more, even if a municipality does provide its side of an argument for establishing a government-run business, in reality it is very difficult to actually prove that this is the only or the best way to achieve the policy objectives.

Currently, there are no cases addressed by this procedure, yet Parliament attempted to remove this rule from legislation. Even though it did not make it into the spring session of Parliament, it is very likely that the issue will be revisited in the fall session of 2017.

CONCLUSIONS

It seems that SOEs are here to stay. While we should not abandon plans to privatize them if favorable conditions arise, we have to start thinking how to limit their expansion in a world where liberalism and free market have lost some of their luster. Regulation, or more regulation, is anathema to free marketeers, but I fear that, currently, it is one of the few (if flimsy) options to contain the expansion of the government into the economy.

If things go our way in the end, and governments return to privatization, the regulation of SOEs will be seen as a temporary measure in uncertain times. If, in the long run, things turn sour and governments continue their march into the economy, working on legal barriers to curb the government is a worthy and timely investment. ●

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Georgia's Succesful Public Sector: Background and Lessons

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GIA JANDIERI

Georgia became independent in 1991 after the country cut economic ties with Russia. It immediately eliminated the market for produced goods and caused the limitation or stoppage of more than 900 state-owned factories and thousands of collective farms. However, the privatization of land, apartments, houses, and factories did not help immediately. Post-Soviet Georgia, though being one of the most privately (though illegally) run economies, needed a better business environment and business skills and environment. Nevertheless, that development had to "wait" until the political situation was ripe for true and comprehensive free market reforms after the Rose Revolution in November 2003 and the presidential and parliamentary elections of 2004.

> IN THE 2000S, GEORGIA ATTEMPTED A SECOND STAGE OF PRIVATIZATION. YET SOME OF THE BIG COMPANIES (LIKE GEORGIAN RAILWAYS) REMAINED UNDER STATE OWNERSHIP

HIGHLIGHTS OF REAL PRIVATIZATION[1]

"Voucher privatization" did not achieve the desired outcome. Factories with outdated technologies, producing low-quality goods, were unable to attract foreign investments and suffered from a Russian energy blockade. That significantly slowed down the privatization process. In the 2000s, Georgia attempted a second stage of privatization. Yet some of the big companies (like Georgian Railways) remained under state ownership. A significant part of arable lands remains under public ownership, and most private land needs registration.

The indexes of economic freedom, by the Fraser Institute and the Heritage Foundation, clearly indicate that there are private property protection problems in almost all post-communist countries. Georgia, though not an outsider on those lists, still lags behind developed Western nations.

After two waves of privatization, the state still keeps several hundred public companies (however, most of them are not in operation). Although almost all clinics are private in the health care system, a huge majority of high schools are state-owned. The efficiency of state-owned institutions remains very low — they either

[1] Georgia's privatization was legally outlined as early as 1991 by the Law on the Privatization of State-owned Enterprises in the Republic of Georgia. The voucher scheme occurred between January 1992 and July 1994. It did not work for many reasons, but the main one was that loss-making entities (the vast majority of state-owned firms) were not liquidated. The new "reform" was attempted by the 1997 Law on State-Owned Property Privatization, but that failed too. The "seller" (the Ministry of State Property) was bound by approvals, there were more than 20 exemptions from privatization, and there was a myriad of employee privileges for the post-privatization period. All those hurdles were resolved by the 2004 privatization program (spearheaded by Kakha Bendukidze), which was based on a simple principle: SOEs go those individuals or organization that paid top price.

operate with subsidies or stagnate and waste the scarce resources of the poor country.

Privatization, however, is not only a sale of government-owned properties: It is first and foremost a process of separating the government from intervention in many other areas, not just the economy. Georgia is a positive example, and an almost unique exception in this respect.

Georgia ended the taxpayer-funded welfare system in 2008 after eliminating the social taxes and the state funds managing their distribution. The decision was long in the making by events happening before and since the collapse of the Soviet Union. It made Georgia's fiscal system one of the cleanest and the most sustainable. It has no official social obligations or liabilities toward its citizens, who were incentivized to take care of their own fate in old age and health[2].

In 2011, Georgia adopted a special amendment to the constitution which restricted government spending and taxation powers. While restrictions on the public debt and fiscal deficit are similar to the Maastricht Criteria, the others imposed a 30% public spending to GDP ratio, and a nation-wide referendum requirement for a tax rate increase or new tax. In this respect, Georgia is unique.

> THE STATE OF THE ECONOMY BEFORE THE FORCEFUL INCORPORATION OF GEORGIA INTO THE SOVIET UNION WAS A TREMENDOUS SETBACK IN GEORGIA'S ECONOMIC AND POLITICAL DEVELOPMENT

Obviously, the constitutional provisions presuppose that there will be less pressure on the government for tax increases. That would make the country's economic future more predictable and advantageous. It can be said with great certainty that those important reforms have already saved Georgia's economy from problems after populist promises were given during the 2012 general election[3].

[2] The reforms were fiercely criticized. See Simon Gabritchidze, An Analysis of Recent Health System Reforms in Georgia: Future Implications of Mass Privatization and Increasing the Role of Private Health Market, Institute of Public Affairs, Warsaw, Fellowship Program for Georgian Public Policy Analysts Policy Papers 06/07. Later, critics recognized "some success": Kate Schecter, The Privatization of the Georgian Healthcare System, Anthropology of East Europe Review 29(1) Spring 2011, pp. 16-22. A more detailed account of the outcome may be found in: Frederik C. Roeder, Andria Urushadze, Kakha Bendukize, Michael D. Tanner, and Casey Given, Healthcare Reform in the Republic of Georgia: A Healthcare Reform Roadmap for Post-Semashko Countries and Beyond, April 6, 2014. A more contextual review of Georgia's privatization may be found in: Larisa Burakova, Robert Lawson, Georgia´s Rose Revolution: How One Country Beat the Odds, Transformed Its Economy, and Provided a Model for Reformers Everywhere, Guatemala, Universidad Francisco Marroquín, 2014, and: Лариса Буракова. Почему и Грузии получилось. Москва, Альпина Бизнес букс, 2011, especially chapter 5.

[3] The Georgian Dream coalition of billionaire businessman Bidzina Ivanishvili won a majority of seats, but besides the promises, it was not successful in reversing the reforms (although it seeks new options to revoke those constitutional arrangements).

The other systemic achievements of Georgia's public-sector reforms are the minor improvement of core government services, like public registers of citizens and properties (and issuance of respective documents), taxation, and government procurement.

Those reforms made Georgia's public sector very efficient and transparent. For instance, any person in the world who has internet access can observe, participate, protest, block, and dispute the purchasing activities of government bodies in Georgia. A similar system is being designed for Ukraine, but its implementation has been delayed[4].

THE PRINCIPAL SOVIET LEGACY

The state of the economy before the forceful incorporation of Georgia into the Soviet Union was a tremendous setback in Georgia's economic and political development. The Bolsheviks did everything in their power to destroy the economy of Russia and the forced members of the Soviet state. They eradicated trade ties, specialization, working and business ethics, and (physically) human capital. A centrally planned economy is based on strict commands and, therefore, cannot accept private owners' opposition to these orders. Understanding the difficulty, the Bolsheviks exterminated the owners as a potential opposition power to their dictatorship[5].

The elimination of private property and their owners created a new atmosphere where nobody wanted to work because of a lack of incentives. The situation resulted in waste of the resources.

In a "normal" country where private ownership is dominant, people tend to keep their strong property rights attitudes – "that's not mine, therefore it is somebody else's (maybe public), and so I need to show respect to expect the same attitude from others". Making everything belong to the government eliminated the need for such kind of cooperation. And the dispersed ownership of companies and their resources kept the owners – citizens – distanced and (rationally) ignorant to their rights to control the assets.

In some republics like Georgia, private initiatives appeared in the 1950s during times of moderate softening of the regime. Private tutors, direct (but hidden) payments to physicians, and factories used for underground production of goods in demand (like fruit juices) became an essential part of life in Georgia. Simultaneously, collective farmers would sell all of their products they received in their tiny land parcels. The productivity in their own (so-called "individual property") space could be several

[4] The reform's core institution is the Public Service Houses (PSH), or Houses of Justice. It was launched in 2009 and finalized by mid-2011, was coordinated by the Ministry of Justice, and supported by the EU (Human Dynamics Program) and USAID (the U.S.-based company "Senteo" was involved in service-area planning and interior design). PSH provide 250 services to citizens. In 2012, Georgia ranked globally as follows: 1st place in property registration, 4th place in construction permits, 7th place in ease of starting a business, 16th place in doing business. See: Fighting Corruption in Public Services, Chronicling Georgia's Reforms, Washington D.C., World Bank, 2012.

[5] It is often forgotten that the first task of the infamous Cheka (short for "All-Russia Extraordinary Commission to Combat Counterrevolution, Speculation, and Sabotage") was, except for punishing opponents of Bolsheviks in the constitutional elections of November 11, 1917 (in which 75% of the vote was against them and they won 125 of 707 seats), to deal with the general strike (it erupted on the 13th day of the "Revolution") of all industrial trade unions, and invade the private banks and confiscate the savings of the population. The same "policy" was applied, in a more efficient manner, in all newly forced members of the Soviet Union and postwar Eastern Europe.

> THE CORE PROBLEM WITH STATE-OWNED ENTERPRISES (SOEs) WAS THAT STATE OWNERSHIP DESTROYED INCENTIVES TO USE RESOURCES IN A PROPER AND EFFICIENT WAY

times higher than in the collective lands. The leaders of the companies and the collective farms could feel themselves as *quasi* owners of them, as they could get some self-satisfaction and illegal financial (or in-kind) benefits.

The core problem with state-owned enterprises (SOEs) was, therefore, that state ownership destroyed incentives to use resources in a proper and efficient way. Factories also lacked any incentive to improve quality, use better technologies, and economize their resources. The central planning authorities were to decide who needs to produce what, who buys it, and at what price. There was no competition and no motivation to do something better than others – consumers had no choice, and the government decided everything.

Any initiative by company leaders could be dangerous – they would prefer to avoid any responsibility in regard to the quality of the produced goods. Locally initiated changes to the shapes, colors, materials, or quantities of produced goods would shift responsibilities to their level. Punishment would be very severe. Simultaneously, those managers would lose their opportunities to steal the resources, use them for illegal productive activities, and use the factory space for other initiatives.

THE LOGIC OF THE COLLAPSE AND TRANSITION TO THE MARKET ECONOMY

Most post-communist nations quickly reintroduced private property. The formal act had different scales of impact in the countries. The reasons for this diverse success can be the environment in each country and how long a country lacked private property. Most of the countries (or, rather, their political establishments) have kept many companies in state ownership in the name of social welfare, retaining former "profitability" and "market" shares at home or abroad, or fearing unemployment. The real fear was of losing votes and opportunities to appoint friends to SOE boards of directors.

The principal questions to ask are:

- If an enterprise is a normal company, and can make a profit, then why should it stay in the public sector when it can operate in the private sector?

- If it is losing public funds, can the government risk public money? Clearly, the State Audit Office must be very unhappy about such a risky and inappropriate use of public resources;

- What is the strategic end: to lose or save public resources, to make people better off or worse off, and who benefits and who loses from such "strategies"?

- How can an SOE decide independently on its prices if a government or political establishment is granted the opportunity to use the price as a reason to attack (or use a social argument as an excuse for intervention in price setting, industrial design, management, or personnel decisions)?

A tacit answer to those questions and related matters is to be found in the laws and rules that try to regulate SOEs. There is a need for a closer look at SOEs and their functions.

GOVERNMENT INTERVENTIONS

Traditional explanations by economists for why we need to use government intervention into the market process (or private life) can vary from monopolies to non-excludability, and all these theories tend to argue for one assumption: The private sector is inefficient in supplying some goods and services with good prices and quality. (There is an issue in this assumption itself – it cannot define what is "good".)

The free market position for this is simple and effective – good prices and qualities mean market-competitive prices and qualities which are accepted by consumers. In other words, any ideas of necessary government interventions are strongly limited with the opposing principle of economic efficiency.

Cost-benefit analysis can ask us to consider the political costs and benefits of state intervention. Here we can talk of the consequences of unlimited government action and unlimited majority power in a democratic system. It is not easy to calculate if all the contributors to public finances are the equal beneficiaries too. However, public finance now plays a redistribution function rather than a productive one. The state-run pension, health care, transportation, and educational organizations spend a major part of the public budgets of nations, but not so much in Georgia.

Thus, for instance, any taxpayer who contributes to publicly operated roads can be one who rarely uses the roads. But a taxi driver who drives thousands of kilometers per month contributes less than they benefit from the same roads.

Cost-benefit analysis can clearly indicate that, in pure economic calculations, any government intervention can be economic failure, and these costs can be only politically justified and financed. The beneficiaries of such redistribution are the incumbent politicians and bureaucracy, who promote the use of the democratic system for justifying state interventions. Their intention is to please (usually in an illusionary manner) the majority of voters at the expense of others for whom the costs are much higher than the benefits[6].

When is governmental intervention unavoidable? When politicians have no other choice and need to spend money to get additional votes? And if not getting such powers, they threaten bigger political turbulences which could bring more economic failure?

In the era of declining economic growth among wealthy nations when their governments reached their highest level of public debts and liabilities, their choices for improving growth with better policies are strongly limited. Getting out of the mess requires time — a longer period of time that last beyond one or two peaceful political cycles.

[6] On fiscal illusions, see: James Buchanan, Public Finance in Democratic Process: Fiscal Institutions and Individual Choice, chapter 10, James Bucanan, Collected Works, vol. 4.

> A BUREAUCRATIC VERSION OF PRICE DETERMINATION CANNOT MAKE MUCH SENSE, ESPECIALLY IN DYNAMIC AND COMPETITIVE MARKETS

PRACTICAL APPROACHES TO SOE POLICY

The first idea for SOE policy can be limiting SOEs' risky operations while simultaneously giving it the highest level of autonomy. But such autonomy entails the risk of being eliminated for one political reason or another, while the pressure to bail out public companies or intervene with its management remain strong and omnipresent.

In addition to the theoretical problems related to the state ownership of properties and companies, there are practical macroeconomic problems that make SOEs ineffective:

1. Difficulty of maintaining price

Any attempt by an SOE to calculate prices on their goods and services can become an excuse for periodic or permanent accusations of wrong-doing and a demand for auditing.

It is obvious that a bureaucratic version of price determination cannot make much sense, especially in dynamic and competitive markets. A bureaucrat or an SOE leader cannot avoid mistakes in a permanently changing economic situation.

Even if SOE leaders find very precise prices in the market and put them on their goods and services, politically motivated people would still argue that there were better choices.

The issue can become insoluble when a change of a government happens. The new government would be interested in maintaining its control over an SOE and will try to find mismanagement by the current managers.

If it appears that SOEs had lower market prices, it can become a reason to attack it because it wastes state resources. Even if the prices were higher than market ones and people were not eager to pay them, it can again be counted as wasting the resources and dissatisfying people.

> FOR SOEs, NOTHING IS GUARANTEED BUT GOVERNMENT AND TREASURY BACKING WITH PROTECTION, SUBSIDIES, AND BAILOUTS

> ANY SOE WHICH ENTERS THE MARKET WITH SPECIAL PRIVILEGES (TAX RELIEF, DISCOUNTED ACCESS TO SCARCE RESOURCES, REGULATIONS THAT ARE TAILORED TO FIT SOEs) CAN EVENTUALLY BE CONVERTED INTO A GOVERNMENT MONOPOLY, WHICH ALLOWS THEM TO FORGET ABOUT EFFICIENCY

Moreover, as market prices permanently change, a SOE can be accused of simultaneously underestimating and overestimating the prices. That is especially easy after some years from the moment when prices were used. It can be difficult to prove what the market prices were, and somebody can still label the differences between market and SOE prices as huge (or claim that the prices were bad for customers).

In fact, accusing the prices of being wrong is easier and more frequent. Quality claims require a higher expertise, but accusations of wrong quality or design can be much easier, though more difficult to prove.

2. Risk-taking

SOEs are ordinary companies and they operate in a competitive environment. Although they sometimes operate in sectors with few or no direct competitors, consumers can always look for alternatives. Therefore, for SOEs, nothing is guaranteed but government and treasury backing with protection, subsidies, and bailouts.

The two sources of risks SOE managers undertake in seeking closer relationships with the government, rather than trying to please customers, are bribery and political corruption in exchange for special privileges.

3. SOE as a monopoly

Any SOE which enters the market with special privileges (tax relief, discounted access to scarce resources, regulations that are tailored to fit SOEs) can eventually be converted into a government monopoly, which allows them to forget about efficiency.

Governments attempt to defend their policies (including maintaining SOEs) with many arguments. They try to invent different reasons for the importance of SOEs and introduce special legislation to save them from competition.

One of the examples of such interventions are so-called "natural monopolies". It is believed that there are some market sectors where there cannot be any substitutes for customers. Even though governments long hindered the private sector from creating alternatives, most of the "natural monopoly" sectors are now operated by private companies without problems for customers. Moreover, government regulations are mostly to blame for still-existing artificial problems (like mobile connection roaming prices).

> GOVERNMENT INTERVENTION CAN HINDER MARKET COMPETITION AND CREATE ARTIFICIAL MONOPOLIES

Government intervention can hinder market competition and create artificial monopolies. Moreover, any attempt to remedy this problem with the same government interventions only deepens the problem. Only government intervention can create and save long-lasting monopolies. In contrast, a monopoly in the private market process can be an outcome of the efficient use of resources and successful management, though still controlled by competitive forces (new substitutes, changing preferences).

OPPOSITION TO PRIVATIZATION

The opponents on the political left (though not necessarily from such political parties) tend to explain their interventionist positions with two reasons:

1. Markets can fail to provide certain goods and services if this is not profitable for private companies to produce and sell them.

2. There are poor people who cannot afford some essential goods and services.

Any attempt to solve such problems must be first evaluated on economic efficiency. The opponents of free market solutions need to provide, with measurable data and results, the consequences of state interventions. Or, if someone thinks there is a market failure and the government can solve it, then we need to see short- and long-run measurable outcomes from them. They need to provide us with calculations of improvements they intend to reach, and also how to ensure that the best people are elected and appointed in political and executive positions.

For instance, when someone advocates affordable health care, they need to show how this policy can maintain a better quality of service, being simultaneously free of coercion, and incentivize healthier lifestyles and responsibility.

One of the most popular so-called market failure issues the left propagates is the monopolistic power sometimes appearing due to the efficient use of resources by a successful company (like Google). Many agree that it can become a problem for a short period of time before alternatives appear. But the state intervention alternative is also a monopoly under government protec-

> ANY ATTEMPTS TO REGULATE MARKET FAILURES BY A STATE CREATES PRIVILEGED GROUPS

tion. Moreover, any attempts to regulate market failures by a state creates privileged groups[7].

Oftentimes, any failure of government intervention is excused by the left with one sentence: That was not genuine socialism, there were mistakes in the policies, and there were wrong leaders.

First of all, those mistakes have already taken millions of lives. Still, when they say there can be better policies, we need very precise calculations of how to avoid mismanagement and misuse of resources. When SOEs enjoy real monopolistic powers and their bosses in the government are simultaneously monopolistic in their political powers, they are very short-sighted.

One of the biggest differences between a public company belonging to the state or private owners is that it is much more difficult to abandon ownership of a state company than of a private one. In fact, the abandonment power is one of the most important parts of ownership rights.

[7] For instance, regulation of communications is technically and economically nonsense, but it has a very important political benefit for governments. Moreover, that is an essential part of their power to control individuals.

Knowing about this problem, SOE management feels much less pressure on them than if the SOE was a private company working in a competitive environment. That invites both inefficiency and less-qualified managers who prefer government privileges to economizing and pleasing consumers. Such managers are addicted to a free lunch and living at the expense of others (See Bastiat).

It is clear that opposing such issues is only possible if someone is only busy with political goals and disregards economic principles (See Sowell). The political goals are easier to achieve with emotional argu-

> THE CURRENT POLITICAL SITUATION LEAVES FEW CHANCES TO USE ECONOMIC EFFICIENCY ARGUMENTS

ments rather than economic ones, as the latter offer mostly long-run solutions. Politicians need tangible outputs immediately. Outcomes like better education quality after 10 years are much less interesting for politicians and voters.

Undoubtedly, the current political situation leaves few chances to use economic efficiency arguments. For instance, it is always hard to oppose paternalistic or protection-

> TO TRY AND KEEP SOME ECONOMIC EFFICIENCY, A NATION NEEDS TO LIMIT AND RESTRICT GOVERNMENT POWERS, INCLUDING SOE EXISTENCE AND FUNCTIONS

ist policies when your neighbors use them — voters would rather vote for politicians who show visible effects and never tell them complicated stories of side-effects that destroy their choices and lives.

But to try and keep some economic efficiency, a nation needs to limit and restrict government powers, including SOE existence and functions. That keeps the chance to improve the level of living conditions for everyone (See Thatcher).

There are two major myths used to justify SOEs and delay privatization:

1. "Strategic importance"

Many supporters of SOEs and privatization opponents claim that, if privatized, some strategically important companies or functions will be used against the nation by its enemies. In fact, those opponents never say what the strategy is, where it was written, or what are its goals. The most important goal any key sector for the economy needs to accomplish is that it works. Someone who is skeptical of privatization and thinks that, in some cases, some important sectors are vulnerable, needs to show how government intervention solves the issue. Asking free market advocates to justify privatization is wrong – private people are served by the government, which is obliged to report to the people.

But if we need a solution for privatizing an important sector, institutions, or functions, then it is simple: Sell only in the transparent market and in a transparent way. Do not allow hidden and political groups to buy the property.

Before doing so, it is essential for politicians to create certain measurable conditions and procedural rules to determine why something is strategic, what its objectives are, and how to accomplish its goals (these shall apply to ordinary SOEs and government functions in general). The process must also prove that functions can be better performed by the state rather than a private sector. Just imagine what would be the outcome if mobile communications and smartphones were to be supplied by a state company.

"Is this function very important?" That was the typical question Vato Lejava[8], one of the architects of the Georgian reforms, would

[8] Vato (Vahtang) Lejava, as former deputy state minister of reforms coordination, chief adviser to the prime minister, and chief adviser on economic and governance affairs, and deputy minister of finance (from 2005 to 2012) was the principal drafter and implementer of the constitutional Liberty Act mentioned above, and of sector reforms, privatization, international trade liberalization and improvement of investment climate. In those efforts he worked hand-in-hand with the late Kakha Bendukidze and a team of reformers around President Saakashvili; currently he is rector of the Free University

> WHAT IS ALWAYS BEHIND THE NATURAL MONOPOLY ARGUMENT IS THAT THOSE WHO ARE IN POWER OR WISH TO WIN A GOVERNMENT OFFICE THINK ABOUT THE PERSONAL BENEFITS THEY COULD GAIN FROM SOEs

always ask in a discussion on government intentions. Even if justified, we shall take for granted that only competing private companies could be an efficient provider of a service. A government can just ensure disaster in its provision.

It may also be worth mentioning the current "global roaming prices abracadabra": people tend to think this is a problem crated by private companies and are quick to blame them, believing that it was the "nice", user-friendly EU commission that stopped them. In fact, the regulations implemented everywhere are to protect local territorial markets. The local artificial monopolies are very happy with this, at the expense of unhappy customers. Without those regulations, mobile communication would be easy, cheap, quick to improve, and customers would be also using their (home) cell numbers without problems. We can think differently: Mobile phone numbers are the ID numbers, and here we can see that even ID numbers and personal identification can be easily and quickly privatized[9].

2. The myth of natural monopolies

It is sometimes a stronger argument, as some theorists argue (and politicians use this with pleasure), that there are sometimes natural barriers, like putting pipes in the same place where it is already occupied. In fact, the issue is mostly about how much it can cost to lay more pipe, but not abut impossibility. In some sectors (like communication), this type of argument already disappeared. Again, the problem is in the costs of maintenance and has nothing to do with nature. We can observe how man subway lines run under the most important buildings in New York City, London, or Paris. If the costs are justified, there will be no barriers to add new pipes or cables.

But one should not forget about the alternatives. If there is no water and it is too costly to put new pipes, the solution is to find a better place to live where water is not expensive. Or, any monopoly power is limited by:

- competitors who can appear any time, attracted by the high prices;
- consumer purchasing power;
- the appearance of new technologies which can be accelerated by higher prices set by the monopoly;
- wrong management of the monopoly because of less attention to the market.

In other words, any attempt of the opponents to justify the mythology contradicts their arguments for a natural monopoly if one digs into the microeconomics of the matter[10].

Practically, what is always behind the natural monopoly argument is that those who are in power or wish to win a government office think about the personal benefits they could gain from SOEs or some of the agencies established to perform public functions. Those gains can be access to shares, management posts, control in redistributing public resources, or a chance to appoint relatives or friends to such posts. By the nature of things, politicians hesitate to support privatization and compare its outcomes to the potential personal benefits from maintaining SOEs.

And here a "game of illusions" comes into play: It is easy to massage public emotions and tell the electorate it is unwise to sell Rustavi Metallurgical Plant, a notorious case of outdated technology and loss-making, because "Georgia must be proud" of its history, or because it employs 10,000 workers, and even when privatized, these illusions serve as "justification" for privileges, workforce support schemes, and subsidies[11].

WHAT CAN BE DONE?

Based on the experience of the last 5–7 years, political populism and politicization of economic processes in the current democratic system is unavoidable. Emotions of a different sort could overcome common sense, but we can only expect that this politicization will be limited by economic scarcity. Public debts and other liabilities created by governments can at some point destroy their economies and invite political conflict.

But before this happens and everyone accepts that this policy of SOEs is wrong, we can introduce some special rules for SOEs. Again, this does not mean that SOEs are a good idea. We should simply find a way to restrict existing SOEs and limit the creation of new ones.

Given that democracy is about how individuals behave toward one another and not just about how governments are elected and take decisions to direct the lives of individuals, there are several principles that, to some extent, worked in Georgia:

1. The government is a servant, and therefore has no right to hide anything from its citizens. That includes state companies or any organization financed by the state budget. They need to report to the public about any activities, spending plans, purchasing operations, profits, personal salaries, paid taxes, etc.

2. Governments have no right to risk resources. Therefore, it cannot maintain a business plan which contains risks.

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of Tbilisi and the Agricultural University of Georgia.

[9] This is a proposal of George Zesashvili, a long-standing Deputy Chairman and Chairman of Georgia's Central Election Commission.

[10] See: Julian Simon, The Ultimate Resource II: People, Materials, and Environment, Baltimore, University of Maryland at College Park, February 16, 1998, conclusions.

[11] RMP was established in 1948 as the first fully integrated metallurgical facility in that part of USSR. In its heyday, it produced steel, hot-rolled seamless pipes, and pig iron products, aluminum, or iron, and benefited from its supply of seamless pipes to connect the oilfields of Kazakhstan, Azerbaijan, and Turkmenistan to the mainland Soviet market, plus some export to the Middle East. It was privatized in 2005, but the pretense for subsidies and quasi-subsidies remained. It motivated court litigations between the new owners against the government official that privatized the plant and attempted to impose hard budget constraints.

3. Creation of an SOE should be based on concrete principles and goals. Fulfillment of the principles and goals must be strictly controlled. No SOE can be created or operated if there is a private company operating in the sector of its proposed activities. If there is an SOE operating, but a new private company entered the sector, then the SOE has to be privatized by the end of the next year.

4. Any SOE created by one government must be reapproved by the next government. Failure to reapprove automatically puts the SOE on the privatization list.

5. Failure to fulfill the principles and goals by an SOE automatically puts it onto the privatization list. A government can postpone privatization by only one year.

6. SOEs pay taxes and rent land or building space like all private companies.

7. An SOE has no right to plan profit. It can, however, happen that an SOE becomes profitable. In that case, any profits go directly to the state budget. An SOE that became profitable must be put on the privatization list. Again, governments can postpone privatization by only one year.

8. The institution responsible for SOEs is the State Treasury or a state institution similar by function. The head of the Treasury has a personal responsibility for the financial health of SOEs. The head of the executive branch can appoint some members of an SOE board from the stakeholder public institutions.

9. The government or central bank may not subsidize an SOE by more than 10% of its annual turnover. There can be no subsidies in sectors where SOEs have private alternatives.

10. The government must announce three (or five) major goals for why it is demanding to operate an SOE (or a function operated by a state agency). The goals must be clear and concrete with measurable outcomes and monitoring tools. The quarterly reports must indicate fulfillment of the major goals. Failure to report not fulfilling the goals for two consecutive quarters automatically puts the SOE or the government agency function on the privatization list.

Following this set of recommendations, which were successfully implemented in Georgia, might offer a viable alternative to SOEs in a number of country. Those good practices are an important lesson for both governments and citizens, and a source of inspiration for further developments. ●

*

GIA
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MEMBERS OF 4LIBERTY.EU NETWORK

Free Market Foundation (Hungary) is a think tank dedicated to promoting classical liberal values and ideas. The organization's projects focus on advocating a free market economy and fighting racism. The Foundation's activities involve education, activism, and academic research alike, thus reaching out to different people.

Liberální Institut (Prague, Czech Republic) is a non-governmental, non-partisan, non-profit think tank for the development, dissemination, and application of classical liberal ideas and programs based on the principles of classical liberalism. It focuses on three types of activities: education, research, and publication.

Svetilnik (Ljubljana, Slovenia) is a non-profit, non-governmental, and non-political association. Its mission is to enlighten Slovenia with ideas of freedom. The goal of the association is a society where individuals are free to pursue their own interests and are responsible for their actions.

The Lithuanian Free Market Institute (Vilnius, Lithuania) is a private, non-profit organization established in 1990 to promote the ideas of individual freedom and responsibility, free markets, and limited government. The LFMI's team conducts research on key economic issues, develops conceptual reform packages, drafts and evaluates legislative proposals, and aids government institutions by advising how to better implement the principles of free markets in Lithuania.

The F. A. Hayek Foundation (Bratislava, Slovakia) is an independent and non-political, non-profit organization, founded in 1991, by a group of market-oriented Slovak economists. The core mission of the F. A. Hayek Foundation is to establish a tradition of market-oriented thinking in Slovakia – an approach that had not existed before the 1990s in our region.

IME (Sofia, Bulgaria) is the first and oldest independent economic policy think tank in Bulgaria. Its mission is to elaborate and advocate market-based solutions to challenges faced by Bulgarians and the region face in reforms. This mission has been pursued sine early 1993 when the institute was formally registered a non-profit legal entity.

The Academy of Liberalism (Tallinn, Estonia) was established in the late 1990s. Its aim is to promote a liberal worldview to oppose the emergence of socialist ideas in society.

INESS (Bratislava, Slovakia), the Institute of Economic and Social Studies, began its activities in January 2006. As an independent think tank, INESS monitors the functioning and financing of the public sector, evaluates the effects of legislative changes on the economy and society, and comments on current economic and social issues.

Projekt: Polska (Warsaw, Poland) comprises people who dream of a modern, open, and liberal Poland. It is those to whom a democratic, effective, and citizen-friendly government is a key goal, and who help accomplish this goal while enjoying themselves, forming new friendships, and furthering their own interests.

Liberales Institut (Potsdam, Germany) is the think tank of the Friedrich Naumann Foundation for Freedom dedicated to political issues such as how liberalism can respond to challenges of the contemporary world and how liberal ideas can contribute to shaping the future.

Fundacja Industrial (Lodz, Poland) is a think tank created in Lodz in 2007. Its mission is to promote an open society, liberal economic ideas, and a liberal culture, and to organize a social movement around these ideas. Among the foundation's most recognizable projects are: Liberté!, Freedom Games, and 6. District. The foundation is coordinating the 4liberty.eu project on behalf of Friedrich Naumann Foundation.

Republikon Institute (Budapest, Hungary) is a liberal think tank organization based in Budapest that focuses on analyzing Hungarian and international politics, formulating policy recommendations, and initiating projects that contribute to a more open, democratic, and free society.

Civil Development Forum (FOR) (Warsaw, Poland**)** was founded in March 2007 in Warsaw by Professor Leszek Balcerowicz as a non-profit organization. Its aim is to participate in public debate on economic issues, present reliable ideas, and promote active behavior. FOR's research activity focuses on four areas: less fiscalism and more employment, more market competition, stronger rule of law, and the impact of EU regulations on the economic growth in Poland. FOR presents its findings in the forms of reports, policy briefs, and educational papers. Other projects and activities of FOR include, among others, Public Debt Clock, social campaigns, public debates, lectures, and spring and autumn economic schools.

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New Economic School – Georgia (Tbilisi, Georgia) is a free market think tank, non-profit organization, and NGO. Its main mission is to educate young people in free market ideas. It organizes seminars, workshops, and conferences for education and exchanges of ideas. NESG was founded by Georgian individuals to fill the knowledge gap about the market economy in the country and the lack of good teachers and economics textbooks.

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