Labyrinth of Reform: Privatization in the New Estonia

By Jeffrey Li and Sarena Singhi

Depressing the economic rigor of a country isn't easy. It took legions of career Communists, no-nonsense bureaucrats—a full half century of standardized inefficiencies and precision mismanagement—to wreck Estonia. The aftermath of the Soviet system left a jaded Estonian economy in its death throes, wheezing with obsolescence and addicted to CIS markets and raw materials. When integration with the West was initiated, state owned industries that ignored world standards of quality and competitive pricing fell into an acute structural crisis. The effect was an enormous reduction of industrial output, attributable not only to restructuring and negative productivity shocks, but to the legacies of a closed economy: shortages of cheap raw materials and a lack of demand.

Certainly, there remains much to be reformed in the transition from a communist regime to a free market society. Chief among imperatives is the rudimentary step of privatization, or the transfer of state assets to private authority. The very basis of a new free market economy, of course, is the restoration of private property. Unfortunately for Estonians, a mass privatization effort is an alien undertaking lacking historical precedence. Hence, it comes as no surprise that privatization in Estonia has progressed reluctantly and at times with enormous reservation. In fact, privatization has become a process of paradoxes. Although the nation's stringent post-Soviet reform efforts have been applauded internationally, they have been censured domestically. And as the new free-market system emerges, it faces not only the inertia of the Soviet bureaucratic legacy, but risks tremendous backlash in popular opinion and the expansion of criminal influence in the economy.

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Privatization and the adoption of a more capitalist framework are vital to Estonia's economic survival in an increasingly interdependent world, yet they threaten to upset legal balances and traditional attitudes within the country. The nation's new economic reforms represent a break with its Soviet colonizers, a continuation of certain links with its Western neighbors, and a manipulation of both elements of its past to the advantage of its future. Nonetheless, should the privatization effort falter, the democratic and free market initiatives that have succeeded so handsomely would stymie, igniting, perhaps, a social and ethnic backlash that no one could subdue.

Estonia is a novice at economic independence. Prostrated by various Western powers since the thirteenth century, the nation enjoyed a respite of only twenty years before relentless Soviet subjugation in 1940 (Lieven 55). Moreover, its policy during the first decades of independence had been significantly molded by the models of its Western neighbors, often in obvious mimicry. Whether by forced adoption or willful imitation, Estonia's economy has never been quite its own.

The brief era of autonomy in 1918-1940, however, bespoke Estonia's ability to rebuild and grow its economy. Estonia's first separation from the Russian empire left it in a state of economic disorganization. Although the country faced the same war expenses and the loss of Russian markets that plagued other Baltic countries, (Lieven 61) it had advantages uncommon to post-World War I newly-industrializing nations. Estonia entered its time of self-governance with a shared national consciousness, an educated elite, universal literacy, and an unusually small economic disparity between the capital city and the countryside. Estonia's tremendous economic success during this period was closely tied to its Western neighbors, and it considered itself the most Westernized of the nations conquered by the Soviet Union in 1940. In fact, Estonia actively achieved a living standard during this time that would subsequently attract Soviet Russians to its Western "bourgeois pleasures" *(The Washington Post).*

However, these pleasures soon faced the onslaught of Soviet colonialist economics. Soviet rule of Estonia quickly curbed economic growth and created systems to perpetuate damage. Its collectivization schemes reversed the work of Estonia's autonomous land reforms, which had painstakingly increased the number of farms two-and-a-half times from 1919 to 1939; (Ruan 126) 140,000 private farms were reduced to 365 collective state farms. Soviet policy makers

The capital of Estonia, Tallinn

managed to transform Estonia's predominantly agricultural economy to one of 80% industrialization without raising living standards from the 1940 level (IMF 3). In sum, communist policies created widespread stagnation which virtually wrecked the achievements of Estonia's short-lived 1918-1940 independence (Thomson 39). And to this day, the legacy of central planning threatens the success of the sovereign nation's economic reforms.

At the outset of ownership reform, investor confidence was feeble due to legal uncertainties and pending restitution claims by former owners whose properties were unlawfully expropriated during Soviet occupation. No one was even certain how much real estate or a company's assets were worth because appraisals and western methods of accounting were so uncommon. To appreciate the context of the privatization process, one must imagine whole legal and economic structures simultaneously being built from scratch, while politicians bicker over just how to privatize apartments, restaurants, and factories in a manner that is unconditionally fair and socially responsible. Naturally, the privatization process is one of continual evolution in a vague regulatory framework that is unique to nation-building.

In June 1991 Parliament laid the tentative foundations of the new ownership reform law, which finally outlined the legal procedure for restoring property to rightful owners and described in general terms the municipalization and privatization process. To coordinate privatization efforts, Estonia's government opted to follow the German Treuhand model, a trustee agency which oversees the management and sale of state assets in the former East Germany. Named the Estonian Government Agency for the Privatization of State Property, the new "Treuhand" started its efforts by selling minor enterprises (Soreainen 27).

Privatization thus began with the sale of small state firms, restaurants, and shops to domestic investors and the transfer of housing, schools, real estate, hospitals, and other nationalized property into the hands of municipal ownership. The local government would then restore the property to its rightful owners, retain assets under municipal ownership, or compensate owners with vouchers equaling the value of the property, should restoration be impossible. These vouchers could be subsequently exchanged for state holdings offered later in the course of privatization or invested (Soreainen 29).

Large enterprises—clearly the most important of state assets—were transferred to the private sector by the method of international tender. To attract foreign investors, the privatization agency publicly advertised on international newspapers a roster of state enterprises that were up for auction (EPA). Interested parties would then submit a bid along with a bond, worth five percent of the bid value, in the form of an irrevocable bank guarantee that was valid for 90 days after the closing date. The bond added, more or less, a degree of insurance. Bids would be decided on within the 90 days, and should the privatization agency reject the bid, the bond would be returned (Soreainen 30).

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The bid with the highest purchase price for a company will not necessarily be the winning one. For example, a potential investor offering a higher price per share may lose the right to purchase an enterprise to a smaller bidder with fewer oligopolistic ties. Although each case is deliberated on its own merits, the standard criteria for evaluating a bid include: business plans (for a minimum of three years), employment guarantees, investment pledges, the investor's reliability, prior cooperation with the company to be privatized, the extent of asset-stripping, and environmental considerations (EPA publication). A fire-sale is expressly not in the best interests of the privatization agency, which considers its duty of securing jobs and solid investments as paramount.

In November 1992 the agency announced an international auction of 38 major state-owned enterprises from the industrial spheres of food processing, forestry, engineering and metals, and textiles (EPA). Although the tender created much attention internationally, with bids originating from as far away as Australia, the United Arab Emirates, and South Africa (the most came from Germany), the pace of large-scale privatization and promised levels of foreign investment proved dismal (MOE 87). Overall, ownership reform—particularly housing and land reform—in its early stages proceeded sluggishly as legal ambiguities continued to encumber the transition.

In hopes of animating the privatization effort, Parliament ratified in 1993 the Privatization Law and numerous other legal acts which advanced a clearer framework for the transfer of state property. The Privatization Law brought both small-scale and large-scale privatization under one law and finally secured the necessary legal basis for their completion. Moreover, in place of the aforementioned state property board, the law established the Estonian Privatization Agency (EPA), a new Estonian "Treuhand" subordinated to the Ministry of Finance (MOE 86).

For large state enterprises, the EPA continued using the established method of written pre-negotiation auction, but the agency extended the duration upon which bids were decided and altered the administrative hierarchy. Three additional international tenders were undertaken in 1993 and a fourth in March 1994, offering altogether 166 companies from key economic sectors. Although the overall progress of large-scale privatization gained momentum, only 54 contracts were stipulated in 1993. But privatization advanced vigorously during the early months of 1994, as the EPA sucessfully negotiated 59 more contracts (EPA).

Of some 300 large state enterprises in Estonia, the government has managed to privatize over a hundred of them or their subsidiaries, preserving approximately 14,000 jobs (Baltic Observer 7). More rounds of international auctions are scheduled for 1994, as major utilities, port facilities and telecommunication enterprises remain under state control. The EPA has resolved to finish divestiture through large-scale privatization by the end of 1995. Small-scale privatization, on the other hand, is nearly complete. Notwithstanding legal delays and obstacles, collective farms have been dismantled and returned to families while most retail outlets, food processing comparties, and service businesses have been transferred to the private sector (MOE 87).

The history of the privatization process in Estonia is one of continual development and diversification, where the option of pursuing multiple divestiture paths is increasingly avowed. With international and domestic tenders, the distribution of privatization securities has evolved as a primary method for transferring state property to the private sector. Two types of securities are in use. The first, as mentioned earlier, are compensation vouchers which will be issued to Estonians who are legitimately entitled to restitution. The second are vouchers mandated by the housing privatization law; these vouchers can be used by residents of Estonia to purchase their homes (former Communist Party officials, Soviet officers, and KGB staff are denied this right) (MOE 88).

Vouchers will not be distributed via paper securities; rather, the government has employed the use of the banking system by opening separate accounts for all Estonians entitled to receive privatization securities. Both vouchers will have equal value for a number of purchasing options. The securities will be exchangeable for state assets such as housing and land or they can be invested into pension funds (MOE 88).

Last summer, the public offering of shares became the latest method of privatization. Shares can be purchased with money or privatization securities, but only the shares of prominent state enterprises with strong economic footing can be obtained. Additionally, the distribution of shares is regulated, as a majority of shares will be reserved for a core of investors, domestic or foreign, with coherent business plans to ensure solid corporate governance. Minority shareholding will be the position of local investors. The ultimate aim of public share offering is to set the early foundations of an Estonian stock exchange (EPA).

On the lighter side of the transition, Estonian businessmen are learning to turn their bureaucratic inheritance into their advantage in the privatization process. One of the nation's new breed of businessmen exemplified this optimistically manipulative spirit in declaring that

> With us, making the most of the Soviet jungle can be safe and fun.... Our clients do not profit in spite of the jungle economy. They profit due to it! And... the fifteen Soviet republics taking steps towards free economy... need reliable partners. Let us take care that they find you (Thomson 143).

Nevertheless, the Soviet regulatory legacy remains a significant hurdle to sustainable privatization in Estonia. The absurdity of many Soviet and post-Soviet laws compel even respectable businessmen to break them to survive. The situation is no less difficult for law-enforcers: police complain of the blurred distinctions between legality and lawlessness in economic crime and their inability to enforce outdated laws. Until the spring of 1993, Estonia prosecuted for "spontaneous privatization," (Lieven 339) whereby managers and select workers form a private company within a larger state company in order to produce at low state prices and sell for market prices domestically or in the West. Though spontaneous privatization was often done harmfully as asset-stripping, it was also effected only as a means of ensuring observance of contracts; the blanket criminalization of it reflected a degree of paranoia on the part of the Estonian government (Lieven 340).

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Such suspicion, though, was not insupportable nor exclusive to the government. The spread of "the Mafia" is a documented phenomenon in much of the former Soviet Union. The term "Mafia," eagerly integrated from the West into post-Soviet vernacular, is a general description of the underworld; it is used to denote criminals from minor cigarette smugglers to organizers of broad extortion networks (Lieven 345). Organized crime presents a very real threat to the viability of Estonian privatization, for there is a strong possibility of the Mafia acquiring significant sections of the "legitimate" economy.

The use of the term "Mafia" as a nationalist depiction of the unattractive side of the free-market (Lieven 346) represents another peril to privatization in Estonia—popular distrust of capitalism and businessmen, historically embedded in the Estonian consciousness, has proved difficult to uproot. They were not Estonians but Caucasians and Jews who had privately traded and tested the limits of the Communist system under which Baits had lived better. The persistence of this hostile stereotype is apparent in an Estonian farmer's declaration that

> The word "businessman" in Estonian has always had a bad sound... has always suggested speculation, crookedness, foreigners coming here to steal things and disturb our peace. And businessmen today aren't making this picture any better.

Despite public animosity to capitalist reforms, the Estonian government has made tremendous economic advances along these lines in recent years. Indeed, many consider the country's turnaround a miracle of sorts, although members of Estonia's parliament will insist it is not. They credit their radical reform package. The real miracle of macroeconomic stabilization, they assert, lies in air-tight monetary policies and fiscal restraint. A model of discipline, Estonia's government has slashed subsidies, freed prices, and shunned bail-outs, negotiated liberal trade policies and restricted the money supply; all this, while keeping the budget balanced to the senti, true to the proverbial thriftiness apparent from its early twentieth-century success (Soreainen 27). The economy's response has been extraordinary: inflation is down from quadruple to single digits, the GDP registered real growth in 1993, re-orientation with Western markets has been at a dramatic pace. Of all the former Soviet republics, not one can match Estonia's economic dynamism.

Its economic success, however, is rendered uncertain by more subtle Soviet legacies than the bureaucracy and open mistrust of capitalism. Estonians, embarrassed to be regarded as a post-Soviet people, have been more culturally conditioned by their colonizers than they would admit (Lieven 21). Although almost everything in Estonia has been done in a near-Western way since 1991, the lack of quality control and the extra effort in workmanship that define Western markets still impede integration into Western trade. The Soviet habit of mistreating customers also still often overrides the profit motive and threatens the success of private business (Taapepera 216).

Although privatization has made significant strides, the slow tempo of the process is not conducive to the renewal of the economy. When ownership reform languishes, entrepreneurs and business cannot attract the adequate levels of foreign investments which import the managerial and technical know-how needed for survival in West. Thus, the acceleration of ownership reform, especially the privatization of large state enterprises, remains a key issue. Of course, the enormous operational and financial deficiencies of these state companies deter many foreign investors. Some of these businesses, no matter what the level of investment, are clearly doomed. Those enterprises which cannot remain in production should be privatized purely as real-estate. For the state companies that do show potential but are in dire straits, restructuring prior to privatization (not after) needs to be executed. Since neither the Estonian government or the managers of the enterprise have the capacity to direct a major restructuring initiative, outside parties should be contracted to protect the productive assets of the state company and finance the restructuring process (i.e. debt relief, operational and legal restructuring, developing marketing strategies, management/staff training) (World Bank Dec).

The lack of clarity in the legal framework designed by Parliament, the Ministry of Economic Affairs, and the Privatization Agency also serves to decelerate the process of privatization and needs to be addressed. To further hasten the privatization effort, government could enlarge the staff and resources of the EPA so as to extend use of the tender process. There also exist the options of utilizing additional selling agencies on top of the EPA, offering more public offerings, and allowing investors to initiate sales (World Bank Sept).

Privatization in Estonia is an intricate maze of bureaucratic legacy and culturally-imperiled innovation. Rooted in aspirations for an autonomous economy and national identity, the privatization process in the richest former Soviet republic proceeds precariously, as market pressures and socialist sentiment try to dictate its direction. If anything, exploring further divestiture paths promises more discussions and open debate as Estonians anticipate their future, something they now forbid themselves never to let someone else own.

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