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In Search of Owners

Lessons of Experience with Privatization and Corporate Governance in Transition Economies

Cheryl W. Gray

Although each approach to privatization has its advantages, well-designed voucher privatization may best meet the objectives of feasibility, governance, fairness, and institution-building.

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Summary findings

Gray reviews the goals of privatization and evaluates various methods used to achieve them in different transition settings. The task is not only to change ownership but to create good corporate governance and to further the development of legal norms and supporting institutions needed in full-fledged market economies. Initial results of privatization programs are only part of the picture. How they foster further evolution of ownership is equally important.

Experiments in privatization abound, from extensive efforts at sales to strategic owners (as in Estonia and Hungary), to programs based primarily on insider buyouts (as in Russia and Slovenia), to innovative mass privatization programs involving the creation of large and powerful new financial intermediaries (as in the Czech and Slovak Republics and Poland). Each approach has inherent strengths and risks. But if the objectives are to sever the links between the state and the enterprise, to school the population in market basics, and to foster further ownership change, the initial weight of evidence seems to favor significant reliance on voucher privatization, especially given the difficulty most countries have finding willing cash investors.

Formal programs of enterprise privatization are often only a small part of the picture, although they get the most attention. Even where formal privatization has been slow (as in Bulgaria and the Ukraine), a process of asset “recombination” is occurring, often behind the scenes — whether a recombination from state to private firms or from some private firms to others. In the Czech Republic, for example, the ownership of enterprise shares by funds and of fund shares by individuals will change through formal and informal trading, but the ownership of enterprise assets may also shift to some extent as owners or managers sell or spin-off assets into new companies. In Russia, this shifting of assets to new, more closely held firms may be quite widespread, as managers with small minority ownership stakes in newly privatized firms try to gain greater control over assets. As one Hungarian observer noted, this is the period of “primitive capital accumulation” in the post-socialist world. Formal programs may lay important ground rules but uncertainties of every type overwhelm most formal efforts at privatization. The final outcome is far from predictable.

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**IN SEARCH OF OWNERS:
Lessons of Experience with
Privatization and Corporate Governance
in Transition Economies**

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In Search of Owners: Lessons of Experience with Privatization and Corporate Governance in Transition Economies

Socialism's primary defining characteristic was the state ownership of virtually all productive assets. Moving from state to private ownership, and creating the conditions in which privately owned entities can thrive and prosper, are the main tasks of the transition from socialism. This paper summarizes the policy lessons of experience to date with privatization of medium and large enterprises in transforming socialist economies. It attempts to describe the complex and intertwined goals of privatization (far more than simply transferring property rights), the pros and cons (to the extent we know them¹) of various methods used to privatize state enterprises,² and progress achieved to date in various countries.

I. THE GOALS OF PRIVATIZATION

The privatization task goes beyond changing ownership of assets per se. Privatization programs in transition economies should be evaluated on three broad dimensions: (1) the corporate governance mechanisms they create, (2) the supporting institutions they foster, and (3) the extent to which they create a self-sustaining economic and political reform process. While this paper focuses primarily on the technical effectiveness and economic impacts of various forms of privatization, their political impacts—including their perceived fairness, their political legitimacy, the extent to which they create new decentralized centers of political power, and their contribution toward creating a class of property owners who favor and support continued liberalization and reform—are equally important. Although some

¹ Two caveats are in order. First, it is still quite early to search for lessons, as the transition experiment is still underway in all formerly socialist economies. Second, cross-country comparisons are dangerous, given the differences among countries in initial conditions. However, experience to date may provide some benefits of hindsight to relative latecomers in the transition process.

² This paper focuses on privatization of potentially competitive enterprises in industry, trade, and services. It does not discuss privatization of utilities, farms, or state-owned real estate outside of the enterprise sector (whether commercial, agricultural, or residential).

governments judge revenues to be an important goal of privatization, it is at best secondary to the three key objectives noted above.

The patterns of ownership immediately resulting from any program of privatization are unlikely to be optimal. Initial ownership may be too dispersed, or it may be concentrated in the hands of entities that are unable or unwilling to use it efficiently. A critical determinant of the longer-run success of any privatization program is therefore the extent to which ownership rights can change and evolve to more efficient forms. Programs that spur institutional development, in particular the growth of capital and asset markets, will have a distinct advantage in this regard.

A. Creating "Real" Owners

The primary economic goal behind privatization is to create true representatives for capital, and thereby to change the fundamental objectives of enterprise owners toward greater efficiency. Although the state was the dominant owner of productive assets during socialism, the state itself was, always and everywhere, an amorphous collection of disparate interests. No one individual or group of individuals clearly reaped the gains from more efficient use of scarce capital, as private owners do in capitalist economies. Given that the interests of capital were weakly represented if at all, other interests—whether those of the Communist party, the state security apparatus, branch ministries, workers, managers, or local government officials—controlled decisionmaking. The result was extensive, ad hoc, *ex post* redistribution between firms and/or individuals, often from winners to losers to keep the latter afloat, that undermined incentives for efficiency.

Creating "real" owners is not sufficient to ensure changes in the behavior of managers, however. These owners must also have the power, incentives, and capability to practice effective corporate governance, i.e. to monitor managers and assure that they act in the best interests of the owners. For small firms this is straightforward, and indeed in most small firms the owners and managers are one and the same. For large firms, however, the likely separation of ownership and management creates the need for monitoring. Although shareholder monitoring is only one of numerous constraints on managerial behavior in

advanced market economies, it is likely to be more important in the early stages of reform in CEE economies to the extent that markets for products, capital, and/or managerial labor are still underdeveloped and thus may not yet exert strong competitive pressures on managers.

Shareholder monitoring can be passive or active. Passive shareholders rely on "exit" as their main discipline on managers, while active shareholders rely more heavily on "voice". The U.S. model is heavily weighted towards "exit," while the German and Japanese models rely more on "voice" (Roe, 1993). In Central and Eastern Europe, where stock markets are still in their infancy, exit is unlikely to be an efficient and widespread option for most owners for some time to come, and thus active shareholder monitoring is likely to be a critical mode of corporate governance in the near term. Furthermore, markets are not in equilibrium, and major improvements in efficiency are likely to depend not so much on marginal changes in managerial behavior as on successful large-scale restructuring at the firm level. Alternative patterns of corporate governance should therefore be judged not only on how they affect day-to-day decisionmaking but also on how they affect a firm's capacity for radical change and restructuring.

Changes in objective functions are not the only potential benefits that come with real owners. Privatization can also create opportunities to bring fresh capital, technology, ideas, and management styles to firms, thereby complementing the incentive changes brought about by reform to boost the productivity of enterprises. Such injections of new skills are especially important for firms set up to produce in a central planning regime rather than to function in a competitive market system. Whether these other benefits arise, and indeed the nature of the underlying change in the objective function arising from privatization, depends to large extent on the technique used to privatize and the distribution of ownership that results. Different types of private owners—whether "insiders" or "outsiders", individuals or institutions, locals or foreigners—all bring different mixtures of both goals and capabilities to the firms they own. Creating the optimal mix is the corporate governance challenge. Furthermore, the move from public to private may involve intermediate forms of property—neither wholly public nor wholly private—with their own rationality in the particular setting and their own distinct

incentive characteristics (Stark, 1996). *Changing formal ownership is necessary but not sufficient; creating effective corporate governance is the more complex task.*

B. Establishing Supporting Institutions

Although privatization has been pursued by many market economies since the early 1980s, the task of privatization in formerly socialist economies is so much larger that its very nature changes. Indeed, the ultimate goal in the transition economies is more than simply changing ownership or governance per se. Rather, it is to establish the *institutions* of a private market economy. Definitions of property rights and the rules, professions, and organizations that support property ownership must be created, either before or in tandem with the transfer of property rights to private owners.

The enormous magnitude of this privatization task results from the complex and multifaceted legacy of socialism. Private ownership was not the only institution compromised, if never completely abolished, by socialism. The institutions that support private ownership also largely disappeared. Legal frameworks defining property rights, private contract regimes, fiduciary liability, dispute resolution mechanisms, and rules of entry and exit for private firms atrophied. Courts lost much if not all of their independence as well as their role as adjudicators of commercial disputes and enforcers of commercial laws. Banks lost their independent monitoring role over firms and became instead passive funnels for channeling state funds. “Watchdog” institutions that provide critical information for markets to function, such as credit-rating and consumer protection services, accounting and legal professions, and independent journalism, had no reason and/or permission to exist. Finally, socialism inhibited (indeed, often classified as illegal) the development of basic norms and ethics of market conduct and fiduciary responsibility on which so much behavior in advanced market economies implicitly rests. These legal frameworks, commercial court services, financial institutions, “watchdog” services, and norms of behavior need to all be recreated.

C. Creating a Sustainable Reform Process

Transforming property rights and building the institutions of a private market economy necessarily take time. Therefore it is critical that these reforms be politically and economically sustainable and mutually reinforcing. *Yet knowing ex ante how to promote sustainability is not easy, due to the often profound tension between the need to work with existing stakeholder interests and the desire to ensure positive economic outcomes that reinforce the benefits of reform in the public eye.*

On the one hand, experience tells us that the design of a privatization program must take into account the interests of, and distribution of power among, existing stakeholders. Incentive and efficiency problems were pervasive in all socialist economies, but the distribution of power among stakeholders varied between countries. Earlier reforms toward "market socialism" in Poland, the former Yugoslavia, and to some extent Hungary, had given extensive powers to rank-and-file employees to influence decisionmaking in firms. In contrast, employees had very little power in CSFR, where controls during socialism remained firmly in the party bureaucracy and enterprise management, shifting after the "velvet revolution" to the new democratic leadership. The same is true of east Germany, and this facilitated the centralized top-down privatization program of the Treuhandanstalt. The situations in Bulgaria and the former Soviet Union were somewhere between these two extremes; some influence had been devolved to workers, but bureaucrats—and especially managers—retained strong powers. This variation in the distribution of power among stakeholders would profoundly affect the design and effectiveness of privatization programs in the various countries. For example, CSFR and east Germany could design and effectively implement top-down privatization programs; Poland, Russia, and Slovenia had no such option.

On the other hand, it is also clear that accommodation to stakeholder interests has its risks and is often in profound tension with ultimate economic and political goals of privatization. Compromises made to co-opt stakeholders or overcome short-run information or institutional weaknesses may have negative economic or political repercussions down the road that diminish the financial and efficiency benefits of divestiture and undermine long-term economic and political stability. This may occur, for example, if newly privatized firms fail to

restructure due to weak corporate governance, if the results of early privatization are perceived by the public as corrupt or highly inequitable, or if privatization leads to a concentration of economic and political power in the hands of a small domestic elite or foreign investors rather than an expansion of an independent and decentralized local middle class.

Two of many examples of this tension between what is “doable” and what is optimal can be found in Russia and the Czech Republic. In Russia, the preferences initially given to managers to garner political support for the program are proving costly, as discussed later in the paper. Not only is there limited evidence to date of any interest in the new owners in real restructuring of existing (largely insider-owned) firms, but there is growing resentment over the power and means being wielded by managers to gain further control over firms’ assets at the expense of other actual or potential shareholders.³ In the Czech Republic, the designers of mass privatization gave the large state banks permission and encouragement to set up investment funds. This strategy may have arisen from the perceived need to garner public interest in the program (given that the banks, particularly the savings bank, were arguably among the more “trusted” institutions at the time) and thus assure that mass privatization—then a “radical” new idea—could be implemented. Yet it may prove counterproductive in the longer run given the high concentration of economic and political power that has resulted in the hands of a few banks and funds (as discussed in greater detail below), themselves linked to government through both formal and informal ties.

Despite this inevitable tension between *ex ante* accommodation and *ex post* results, certain early steps appear to increase the sustainability of reform in any setting. Countries with legacies of strong bureaucratic control over firms should take early moves to weaken the old links between firms and line ministries—i.e. to cut the pervasive subsidies, to weaken the ministries’ control rights, and perhaps to abolish branch or sector ministries altogether.⁴ This should be accompanied by the quick adoption of a privatization strategy and some means to

³ Whereas only 27 percent of Russians disagreed in 1991 with the statement that “ordinary people will benefit from the introduction of private property,” this percentage has risen steadily to 68 percent in 1995 (World Bank, 1996).

⁴ Old political links can be further weakened by barring former Communists from government service for a period of time, as was done in CSFR.

prevent wholesale looting of the newly "freed" state firms prior to privatization.⁵ These tasks may be most easy to accomplished in the period of "extraordinary politics" (Balcerowicz, 1994) immediately following a political break with the past regime. After these first steps, each stage of a privatization process should ideally create the momentum and incentives for further progress. This occurs, for example, if the new owners arising from the first stage of privatization lobby politicians to design and implement laws (such as corporate and securities laws) that further refine and protect their new rights.

While steady progress is important for momentum, it is still too early to tell if sustainability is closely correlated with speed. Very rapid privatization was pushed in the former CSFR and Russia, in large part on the theory that breaking the links with the state was the primary hurdle, and that the political window of opportunity had to be seized quickly. While many aspects of these programs are impressive and they may yet prove to be major success stories, the initial design decisions taken to ensure speedy implementation have also produced serious problems, particularly in Russia. Their eventual economic and political impacts are still far from clear. In contrast, slower programs of privatization, such as Poland's and to a lesser extent Hungary's, run the risk of barely getting off the ground when political openness to change is greatest, and thus of stagnating before major progress can be achieved. These slower approaches could, however, still prove sustainable with sufficient ongoing government commitment to privatization and macroeconomic discipline. The slowest movers, such as Bulgaria, Romania, Belarus and Ukraine, run the greatest risk of stagnation. The slowness of their official programs does not necessarily mean, however, that no privatization has occurred. Given the weakness of transition governments, the absence of formal privatization programs leaves the door open for massive "spontaneous privatization" (whether "asset stripping" or diversion of income flows) by managers. The economic injustice of this route may eventually lead to political backlash that undermines the sustainability of reform

⁵ This is likely to require a combination of "carrots" (linking the future well-being of managers to the quality of the assets they deliver to the eventual private owners) and "sticks" (imposing strong penalties on managers that divert state assets).

Finally, it is critical for their success of any privatization program that any reforms in property rights be complemented with supportive reforms in other areas. On the macroeconomic side, fiscal and monetary policies should create a stable price system and hard budget constraints on firms. *One important policy lesson of experience to date is that any privatization strategy—whether fast or slow, to insiders or outsiders—is likely to be fairer and work better in an environment with tight macroeconomic constraints, where government subsidies are limited, inflation is controlled, and markets are thus able to exert outside constraints on managerial behavior.* If governments continue to soften budget constraints even for private firms, as they continue to do in many transition economies, the purported benefits of privatization (particularly with regard to incentives) may disappear. On the microeconomic side, reforms in product markets, managerial labor markets, and financial markets complement and reinforce the constraints emerging from owners of equity through privatization. These conclusions do not mean that private ownership and governance are unimportant, but rather that they are not by themselves sufficient.

In sum, the task of privatization is not merely one of changing ownership per se. Rather it involves changing an entire socioeconomic system; i.e. creating the many institutions needed in a private market economy to enable owners to exercise full ownership rights and corporate governance responsibilities. Because this requires both time and political support, policy makers need to consider carefully the interests of existing stakeholders and attempt to create a self-sustaining momentum for change—without sacrificing the ultimate goal of economic efficiency and growth. This is an exceedingly tall challenge. How have policy makers in various transition economies tackled it? The various mechanisms are explored below.

II. METHODS OF PRIVATIZATION

Privatizing large enterprises in transition economies has proven more difficult than most observers originally envisioned. Not only are the goals complex and sometimes at odds with each other, but the firms are often ill-suited to the needs of a market economy. Having functioned under socialism's soft budget constraints, many are overstaffed and inefficient.

Reflecting socialism's efforts to make enterprises the provider of "social assets" as well as income, many are vast conglomerates with housing, medical services, and child care attached to industrial facilities. Having evolved from central planning's need to economize on transaction costs, many are monopolies. Table 1 summarizes the various methods used by the more advanced reformers to privatize medium and large industrial firms and estimates the extent of privatization in each country under each method.⁶ What lessons have emerged from attempts to privatize this important yet problematic sector?

A. Sales to Outside Investors

Before the transition process got underway in earnest, most countries of Central and Eastern Europe wanted to privatize (if at all) through sales of state enterprises as going concerns. They were following the only known experience at the time—that of advanced market economies (most notably Great Britain) and advanced developing countries (most notably Chile) where privatization through individual sales had been successful. Because capital markets were undeveloped in the transition economies, most hoped to sell the bulk of state enterprises directly to large outside investors, generally "strategic" investors with specialized knowledge of the industry in which the firm operates (though Poland hoped in 1990-91 to build a flourishing equity market and divest quickly a significant percentage of its public enterprises through public offerings—a hope that did not materialize). Such "trade sales" were perceived in the early stages of transition to have at least three advantages: (1) they would bring in revenue to the state treasury; (2) they would result in "real" owners who had the knowledge and incentives to govern the company efficiently and the capital to restructure it; and (3) the sale conditions could theoretically be manipulated to take special needs into account in each particular sale.

Although these advantages have indeed proven to exist in some cases, sales to outside investors have proven far more difficult than originally envisioned. Such sales can work when

⁶ Table 3 is not intended to present exact numbers but rather general indicators of privatization progress. Exact numbers are impossible to obtain, in part because the table includes methods of privatization—such as debt-equity swaps or asset sales through bankruptcy—that are separate from commonly-cited formal programs in these countries.

Table 1

**Privatization routes for medium-size and large enterprises
in advanced privatizers
(as of end-1995)**

Country	Sales to outside owners	Management-employee buyouts (MEBOs)	Equal-access voucher privatization	Restitution	Other ^a	Still in state hands
Czech Republic						
Number of firms ^b	32	0	22 ^c	9	28	10
Value of firms	5	0	50	2	3	40
Estonia^d						
Number of firms	64	30	0	0	2	4
Value of firms	60	12	3	10	0	15
Hungary						
Number of firms	38	7	0	0	33	22
Value of firms	40	2	0	4	12	42
Lithuania						
Number of firms	< 1	3-5	65-70	0	0	25-30
Value of firms	< 1	3-5	50-60	0	0	35-45
Mongolia						
Number of firms	0	0	70	0	0	30
Value of firms	0	0	55	0	0	45
Poland						
Number of firms	2	30	6	0	8	54
Value of firms	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Russia^c						
Number of firms	0	55	11	0	0	34
Value of firms	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

^a. Includes transfers to municipalities or social insurance organizations, debt-equity swaps, and sales through insolvency proceedings.

^b. Includes parts of firms restructured prior to privatization.

^c. Includes assets sold for cash as part of the voucher privatization program.

^d. Does not include some infrastructure firms. All management buyouts were part of competitive, open tenders. In some thirteen cases citizens could exchange vouchers for minority shares in firms sold to a core investor.

Source: Kotrba and Svejnar (1994), Blasi (1994), EBRD (1995); World Bank data.

market institutions are in place, as in advanced market economies, but are problematic when such institutions are in their infancy. East Germany successfully privatized virtually all of its state enterprises through sales to outside investors, but only with massive amounts of political will and technical and financial assistance from west Germany. Among the transition countries, only Hungary and Estonia have managed to privatize a major share of their state enterprises through direct sales. Poland and Romania pursued sales vigorously in their early

efforts at privatization but with limited success. All of these experiences provide evidence of the difficulty of this approach in the transition environment.

What are the disadvantages of the sales approach? First, the ability to carry out sales is hampered by the limited amount of private capital (particularly domestic capital), combined with the poor quality of information that makes those with capital wary to invest it. One option, followed widely in Hungary, is to sell heavily to foreign investors who have sufficient capital and are willing to incur risks (or to invest in information-gathering that might decrease such risks). This is a somewhat controversial but nonetheless necessary strategy if a program of trade sales is to succeed (and even then, of course, there will be many state enterprises that foreigners have no interest in buying⁷). A second option is to require less capital up-front, giving owners the right to pay in installments out of the future earnings of the firm. Variants of this approach have been tried, for example, in Estonia, Hungary⁸ and Poland.⁹

A second disadvantage of sales, following directly from the first, is the perceived unfairness of both the process itself and the resulting distribution of ownership rights. This perception results not only from the inability of many ordinary citizens to participate,¹⁰ but also from the nontransparency of the process and the resulting potential for arbitrariness (if not

⁷ Foreign interest has tended to concentrate in certain sectors, particularly those (such as automobiles, food processing, tobacco, and certain consumer products) whose international market structure tends to be dominated by large, oligopolistic firms. Kogut (1996).

⁸ In late 1993 SPA began to implement a program that allowed buyers to pay for firms in installments, with 15 percent paid down and the rest paid over several years at subsidized interest rates. Even before 1993 a special credit program, the "existence loans" (or "E-Loan"), allowed buyers to borrow at subsidized rates to purchase shares in privatized firms.

⁹ One innovative variation of that approach is the "restructuring through privatization" program implemented on a limited basis in Poland. This unique program addressed the market imperfections arising out of shortages of both capital and information by allowing potential owners to bid for an option to buy the firm in three years, with the requirement that they pay only 5 percent of the option price up-front. The winning bidder got immediate control over the firm and thus had up to three years to learn more about the firm's potential and to attempt to restructure it and improve its profitability. The new owners reap any upside gains by exercising their option to buy the remaining 95 percent of the company at the initial bid price. Such owners bear only 5 percent of any downside losses, however, because they can walk away after three years if the firm turns out to be worth less than the initial offer. Although innovative in design, however, the "restructuring through privatization" program has only been implemented to date in a handful of firms.

¹⁰ Those with significant amounts of domestic capital at the beginning of the transition process have tended to be the former "nomenklatura", joined as the transition proceeds by what are often perceived as criminal elements in society. Foreign buyers are also generally viewed with suspicion.

corruption) in individual deals. This lack of transparency and arbitrariness has been notable, for example, in dealings with foreign investors, with whom "enclaves" of incentive packages and legal rules have often been negotiated case-by-case, and in the 1995 Russian "shares-for-loans" scheme.

Third, the approach tends to be costly and slow, due to the sheer magnitude of the job of evaluating and negotiating deals for each company one-by-one and of providing follow-up monitoring to be sure that contract provisions are fulfilled by the buyers. Sales have also been slowed by other uncertainties in the policy environment. These have included, for example, questions over responsibility for cleanup of past environmental damage and uncertainties arising from restitution of real estate to former owners (Rutledge et. al., 1994).

Fourth, the process is complicated and often stymied completely by the difficulty of placing a value on firms to be offered for sale. Accounting standards and institutions inherited from socialism were inadequate to determine the historical value of a firm—much less net present value (on which sales price should theoretically be based). Furthermore, price and other reforms in each firm's environment quickly lessen if not eliminate the relevance of previous experience. There is a profound uncertainty about what firms will look like in the future, i.e. what products they will produce, in what quantities, at what costs, with what financing, at what interest rate, and for what markets. Given this uncertainty it is virtually impossible in many cases, even with reforms in accounting techniques, to calculate even the rough value of a firm.

Finally, like other forms of privatization, sales have been hampered in certain countries by the explicit or implicit power of insiders to block them. This has been particularly true in countries such as Poland and Russia that had decentralized much decisionmaking power during socialism. Furthermore, the strength of the insiders' incentives to block a sale is likely to be correlated with the potential profitability of the firm itself, and thus it may be harder to sell the better firms—exactly those for which there is likely to be greater demand from outside investors.

These many disadvantages have been more debilitating than initially expected. The Treuhandanstalt in east Germany was able to privatize (or liquidate) its 8500 state enterprises

relatively quickly, but at an enormous cost in terms of both skilled manpower and explicit or implicit subsidies to buyers (von Thadden, 1994). The other countries, which lacked a benefactor of West Germany's economic strength, could only move slowly—or adopt radically different divestiture techniques. In 6 years (1990 through 1995) Hungary was able to transfer only about 40 percent of its state-owned assets to private hands through formal sales programs (Table 1, and Pistor and Turkewitz, 1996). With extensive assistance from former Treuhandanstalt officials, Estonia sold most of its enterprises in three years (1992-95). These are the “successful” cases. None of the other countries of Central and Eastern Europe or the former Soviet Union have even come close to these achievements (in large part due to less interest from foreign investors). Overall experience in the region has led most observers to conclude that sales, while a useful pillar in the privatization process, cannot be the sole or even primary method relied upon in transition economies.

In addition to direct sales, another form of sale to outsiders involves floating shares of firms to be privatized on public stock exchanges. This approach is necessarily limited by the very small size of the infant stock exchanges in transition economies. Furthermore, it tends to work only for the very best firms with good financial prospects and strong reputations. It is not an avenue for restructuring, not only because poorly performing firms are unlikely to be listed successfully but also because the dispersed ownership structure that results is unlikely to create real opportunities for owners to exert pressures for change inside the firm. Poland has perhaps had the most success in privatizing “good” firms with this approach, but still has privatized only about two dozen firms in this manner. Initial public offerings (IPOs) are clearly not the answer to the need for rapid and large-scale privatization, but on the margin they can help develop capital markets and share trading.

In sum, sales to outside investors may indeed be the best means to create “real” owners with reasonable incentives for corporate governance and ready access to outside capital, markets, technology, and management skills. However, because of profound problems of valuation combined with its slowness, complexity, and potential inequity, this approach appears to be relatively poor in stimulating needed restructuring in a large number of firms, in supporting broader institutional change, or in creating self-sustaining momentum for further

reforms. It may be the approach of choice for certain excellent firms with willing, capable buyers, but at best it should be seen as one of several pillars in the privatization strategies of transition economies.

B. Management-Employee Buyouts

A second major avenue of privatization involves the discount sale or giveaway of all or part of the company to managers or employees of that company. Most of the transition economies have included management/employee buyouts of a majority of enterprise shares (MEBOs) in their privatization programs to some extent. The majority of the privatizations to date in Poland, for example, have been MEBOs in the form of "privatization through liquidation" under the privatization law. MEBOs have also been the primary form of privatization to date in Croatia, Georgia, Russia, Slovenia, and Romania, combined in some instances with voucher privatization programs that provided the liquidity for insiders (and in some cases a few outsiders) to purchase shares (as described below). Hungary supplemented its emphasis on trade sales with a small but significant MEBO program in 1993 in order to speed up privatization. Although the MEBO model was not at the core of the Mongolian privatization program, many firms privatized through Mongolia's voucher privatization program became in effect MEBOs (Korsun and Murrell, 1994).

A major reason for favoring MEBOs as a privatization tool is their political popularity and thus their practical feasibility. In countries where insiders had strong power over enterprise decisionmaking under socialism (whether workers as in Croatia, Poland and Slovenia, or managers as in Russia and Hungary), those insiders have generally been able to carry over their influence into the transition period and effectively maintain veto power over privatization decisions. In some countries this veto power is explicit; in Poland, for example, the approval of employees is required for a privatization plan of an enterprise to go forward. In most countries, however, such veto power has been implicit; governments could gather sufficient political support to adopt privatization programs only if those programs gave generous benefits to insiders.

What are the advantages of management-employee buyouts as a privatization method?

The first is stated above: MEBOs are relatively fast and easy to implement, from both political and technical standpoints. The second, at least potential, advantage is the one stressed by most proponents of employee share-owning plans ("ESOPs") in advanced market economies. Insider ownership can be both more equitable and, under certain conditions, more efficient than outside ownership (Hansmann, 1990; Earle and Estrin, 1996; Shleifer and Vasiliev, 1996). It can be more equitable because it rewards those who do the work—ironically, the argument at the very heart of socialism. It can be more efficient because it has the potential to mitigate "principal-agent" problems between owners and workers. If information is costly (which it always is, especially in transition environments), the principal, or owner, will not be able to perfectly monitor the agents (the manager and workers). Insiders know more about what is happening inside the firm and, if given the incentive, will be able to shirk, steal, or carry on other practices that benefit them at the expense of the owner. To the extent the employees are themselves owners, the conflict of interest is reduced. Managers and non-managerial employees may be willing to work harder, monitor each other more carefully, and encourage greater productivity if they reap the residual gains.

These potential advantages of MEBOs are counterbalanced by several major disadvantages, particularly acute in transition settings. First, giving preferences to insiders inhibits if not eliminates competition in the privatization process itself. To the extent that more qualified potential owners are not given the chance to participate, the resulting ownership pattern is likely to be suboptimal for the economy as a whole, at least initially. Second, insiders are generally not able to bring new skills and new capital to the company, and socialist managers may have few of the skills needed in a market economy. Initial research in Central Europe appears to confirm that firms, whether small or large, privatized to insiders carry out less restructuring and attract less new investment than firms acquired by outsiders (Earle et al, 1994; Barberis et al, 1995). Third, if insiders own only part of the company, conflicts of interest can arise between inside and outside owners that resemble the "principal-agent" problems described above. If corporate law and disclosure rules are underdeveloped and thus provide few protections for outside shareholders, as is true in virtually all transition

countries (and also in some advanced market economies), outsiders may be unwilling to invest at all in firms with significant insider ownership

Given these disadvantages, MEBOs can lead to serious managerial and worker entrenchment, particularly if other constraints on managers are weak. Insider ownership is likely to work differently when it is the main form of ownership in an economy (as in Russia and Slovenia) than it does when it is in the minority (as in advanced market economies). It also works differently in a transition setting, where other constraints on managers are less developed, than in a full-fledged market economy, where other constraints can be counted on to impose discipline within a firm. If product markets are uncompetitive and securities markets (and thus markets for corporate control) undeveloped, as is often true in the early stages of the transition process, managers and workers may act to preserve their jobs or their control rights rather than improve the functioning of firms. This is particularly likely if macroeconomic policies are weak, and thus if incumbent managers can continue to turn to the state for support (in the form of either direct subsidies or indirect subsidization through the banking system) even after privatization.¹¹ In Russia, for example, some managers of firms with heavy insider ownership have tried to enforce policies (even though on paper illegal) that prohibit workers from selling their shares to outsiders, or have used less transparent means to block either employee or outsider participation or to transfer assets or profits to firms they control.¹² Given the weakness of laws and institutions, the high cost of information, and in some cases the laxity of competitive pressures (due in part to the lack of macroeconomic stabilization), there are so far few if any outside controls on managers to prevent these actions. If such a pattern is repeated on a wide scale and is allowed to become entrenched, this form of ownership may inhibit rather than reinforce the development of the macroeconomic

¹¹ Insiders arguably have a higher tendency to place continuing demands on the state for support, and because of history and politics, the state arguably has a higher tendency to respond to such demands.

¹² For example, managers may attempt to change the form of their company from joint stock to limited liability, because the latter allows greater restraints on sales of shares to outsiders. Alternatively, they may try to convince employees to put their shares in a trust with voting rights assigned to managers. Even when there are no restrictions on workers' voting of their shares, managers may (and do) convince workers that incumbent management is on their side but that outsiders will fire them if allowed in. Finally, managers may try to get around employee ownership altogether by setting up new firms and using their inside information and power to transfer valuable assets to these firms.

discipline, the competition, and the rules and institutions needed in a private market economy.¹³ It may also backfire politically, as the “fruits” of privatization become more and more concentrated in the hands of the few, with growing resentment among those ostensibly included at the beginning but ultimately cheated of their expected gains. The recent success of the Russian communist party reflects in part from disillusion with privatization and the skewed distribution of its benefits.¹⁴

How can the advantages of MEBOs—particularly their political feasibility—be enhanced while their disadvantages—particularly the potential for entrenchment—are mitigated? The approach must be twofold. First, it is critical that the government impose tight budget constraints through macroeconomic discipline to ensure up front that all firms must compete in the marketplace. Second, it is important that this one form of insider ownership not monopolize the entire economy. The government should encourage the development both of other forms of ownership that can compete with MEBOs (through product market competition) and of other owners that can compete with insiders for ownership rights to individual firms (through markets for corporate control). With regard to competing forms of ownership, MEBOs may work well for smaller manufacturing and service firms in sectors open to entry by new domestic entrepreneurs. In those sectors product market competition, combined with a cut-off of subsidies, may keep the insider-owned firms “on their toes”. Foreign competition could potentially do the same for larger insider-owned firms, but in such cases managers have greater capability of turning to the state to block such competition or get support of one kind or another.

With regard to the market for corporate control, there is much evidence from advanced market economies that insider (particularly worker) ownership has an inherent tendency to

¹³ C. Freeland writes in the *Financial Times* (4/15/95, p. 2): “The most damning criticism of Russia’s halting move to a market economy is that reforms have failed to put effective new owners in charge of the country’s factories, thereby allowing old directors to give full rein to the inefficient management practices of the Soviet era and to indulge in the newer pastime of widespread corruption.”

¹⁴ One study calculated that the 19 percent of adult Russians employed in privatized firms obtained 56 percent of equity sold through June 1994, while the 81 percent of Russians who had only vouchers ended up with only 15 percent of the equity (Blasi, 1996). The “shares-for-loans” scheme in late 1995 heightened public outrage as a few banks controlled the “auctions” and got major companies for a pittance.

"degenerate" into investor ownership over time (Earle and Estrin, 1996). This evidence has arisen, however, only in environments with well-developed capital markets. Whether or not the same inherent tendency exists in transition environments has yet to be seen. *The biggest cost of the MEBO approach in transition environments may be that it blocks further ownership change.* For "degeneration" to have even a chance in transition environments with large insider ownership, there must be both a supply of and a demand for shares (i.e. at least a fledgling capital market). To create a supply, shares must be immediately tradable to insiders or outsiders without limitation. To create a demand, outside investors must have not only sufficient capital but also basic information and protections against fraud and abuse by insiders. Both sides of the equation can be problematic. In Russia, for example, some investment funds created out of the mass privatization program, although relatively minor owners of privatized firms, are attempting to increase their ownership stakes in more profitable firms. They (and to some extent individual domestic entrepreneurs as well) are competing with inside managers and banks to buy out employee shares and thereby wrest control of these firms.¹⁵ Who will ultimately "win" in this competition to acquire enduring control over valuable enterprise assets depends in part on how rapidly corporate law, accounting and disclosure rules and practices, and securities markets can develop to encourage both supply and demand, i.e. to block managerial efforts to thwart outside participation or to "strip" assets, and to inform, protect, and thereby encourage outside investors to participate. "Degeneration" of insider ownership in Russia has been relatively slow to date.¹⁶

In sum, MEBOs excel in their capacity to adapt to the implicit or explicit demands of existing stakeholders. However, their ability to create effective corporate governance mechanisms, much less to attract new capital for investment and skills for restructuring,

¹⁵ Other types of potential owners, such as foreign investors, are peripheral at this point, although they may emerge in the second phase of Russia's privatization program.

¹⁶ Early surveys indicate that approximately 65-70 percent of the shares of privatized firms ended up initially in the hands of insiders, with less than one-third of that owned by managers yet far more under the de facto control of such managers given the passivity of rank and file employees. Ownership of the remaining one-third of shares was divided roughly equally between local property funds and outsiders (Blasi, 1994, Earle, Estrin, and Leschenko, 1996). A recent survey indicates that insider ownership may have fallen by some 10 percent in the past two years (Blasi, 1996).

appears relatively weak. For firms that cannot survive without restructuring, with or without new investment, the conflicts of interest that confront insiders when trying to force change may make MEBOs particularly unwieldy. In such cases the insiders may look to the state for help, and, given political pressures, the state may be more willing to listen to workers. If macroeconomic discipline is weak, they may slow the momentum (and even the rationale) for further privatization, impede needed fiscal reforms, and stifle the development of private market mechanisms and norms of behavior. MEBOs may thus work better for viable firms that can generate internal funds for investment, and they may be suitable for small firms without political clout. Indeed, for the latter employee ownership may have advantages in that employees may be more willing to take painful wage cuts to preserve the company (Earle and Estrin, 1996). However, for large distressed firms with major capital needs, MEBOs are unlikely to generate the resources, incentives, and capabilities to undertake large-scale change.

This pros and cons of MEBOs discussed above relate to majority-insider-owned firms. There are, in contrast, strong advantages and relatively few disadvantages to giving insiders a minority ownership interest (on the order of 15-20 percent). One clear advantage is political—that privatization programs are less likely to be resisted and more likely to be perceived as fair if workers participate in any upside gains. Another advantage lies in oversight capacity. Insiders can play an important monitoring role over managers and/or majority owners, particularly if the majority interest is in the hands of funds or foreign investors, who might otherwise have an incentive to “loot” the firms or close them down to stifle competition with other firms under the same owner. These are clearly important advantages given the political fragility and the general weakness of outside “watchdog” institutions in virtually all transition environments.

C. Equal-access Voucher Privatization

Apart from sales to strategic investors and transfers to insiders, the other form of privatization that has been implemented widely across the Central and Eastern European region is voucher, or "mass", privatization. The main similarity among all voucher programs, and the major difference from the sales approach, is the use of vouchers rather than money as

the medium to purchase shares in companies. Vouchers are given or sold at very low prices to domestic citizens, thereby eliminating the shortage of domestic capital that is the core problem with the sales approach. The major difference between “equal-access” voucher programs and MEBO’s using vouchers is the absence of legal preferences for insiders in the equal-access form. This form of equal-access voucher privatization has been implemented (on varying scales) or soon will be implemented in Albania, Armenia, Bulgaria, Czech Republic, Estonia, Kazakhstan, Lithuania, Moldova, Mongolia, Poland, Romania, Slovakia, and Ukraine.

If well-designed, voucher privatization can overcome many of the problems with the various sales approaches noted above, most notably the perceived unfairness, the shortage of domestic capital, and the difficulty of placing monetary values on state assets. Because voucher privatization can proceed rapidly, it can simultaneously stimulate the development of market institutions and create new stakeholders and/or reorient the interests of existing ones toward further reform. Furthermore, it can speedily cut links between enterprises and the state that both inhibit restructuring in firms and put fiscal pressures on the state. However, the road from mass privatization to efficient capitalism is still not an easy one.

The main concern with voucher privatization at its inception, apart from its inability to raise revenue, was its questionable capacity to develop “real” owners with proper incentives for effective corporate governance and with access to new capital and skills for restructuring. The concern over corporate governance arose partly from the very notion of vouchers, i.e. the view that one could not value what one did not pay for.¹⁷ More fundamental, however, was the fear that the resulting distribution of ownership would be inefficient and would interfere with the development of strong ownership interests. Experience has shown, however, that a wide variety of ownership patterns—whether dispersed or concentrated, and complemented or not by the presence of “strategic” investors—can result from voucher privatization, depending on specific elements of design. Furthermore and perhaps most importantly, rather than “lock in” initial ownership patterns (as programs of sales or MEBOs may do in the absence of

¹⁷ Although in theory individuals should be able to perceive of the “opportunity cost” of even gifts such as vouchers, in practice they seem to adopt a sort of “easy come, easy go” attitude to things not paid for. In the Czech Republic, for example, it has been noted that people who invest vouchers in voucher funds are much less likely to make efforts to oversee the activities of those funds than are people who invest cash in cash funds.

developed capital markets), well-designed voucher privatization can stimulate the development of capital markets and share trading—whether shares of companies or shares of funds that own companies—and thus foster further ownership change and speed up the development of a market for corporate control. It can, in effect, “privatize” the privatization process.

1. The Mix of Sales and Voucher Privatization

All transition economies have chosen to follow several privatization routes simultaneously, but the relative importance of different programs varies among countries. The earliest, biggest, and most successful program to date has been in the Czech Republic. It has transferred the majority of state-owned enterprise assets—and on average the majority of shares of each privatized firm—through this route (with the remainder being either sold to outside investors or maintained in state hands). The Slovak Republic undertook a large “first wave” of voucher privatization in 1992, but has been stalled since the split up of the CSFR at the beginning of 1993. Mongolia's program has also been large, privatizing 70 percent of large enterprises by the end of 1992 and applying to 100 percent of the shares of those firms.¹⁸ Moldova's recently completed program is of similar magnitude. Romania's 1991 mass privatization program was much smaller in terms of proportion of each firm covered; only 30 percent of the shares of eligible firms were transferred to Private Ownership Funds ostensibly “owned” by the public; the intention (unrealized and replaced in 1995 by a second and larger mass privatization attempt) was to transfer the remainder to “strategic” owners who could effectively govern and restructure the company. Poland's recently implemented mass privatization is smaller still, covering only about 500 companies (fewer than one-tenth of state-owned enterprises), although for those companies the majority interest is privatized via this route.

In general, larger programs have certain advantages, in that they can include both more firms and a greater diversity of firms. To insure value to participants and thus gain more

¹⁸ Mongolia is the only country that has used only voucher privatization to privatize medium and large enterprises. Every enterprise was sold for vouchers, first in a limited closed subscription to insiders and subsequently to outsiders via the stock exchange (Korsun and Murrell, 1994).

political support, while at the same time divesting firms that might not attract cash offers, it is important to include some of the best firms in the program, along with some of the more marginal ones. And perhaps more importantly, larger programs can achieve a greater degree of privatization in a shorter period of time, given the relative slowness of other approaches.

2. Decisions of Firms Whether and How to Participate

Another characteristic that varies among voucher privatization programs is the locus of decisionmaking power regarding (1) whether and (2) in what form a particular firm will participate. As with the size of the program more generally, this locus evolves in large part from the balance of political interests and powers in the particular country. The government of the former CSFR maintained full authority to choose which firms would participate in the first wave of its voucher privatization, and the Czech government continued to apply this principle in the second wave. To what extent a particular firm would participate, i.e. the mix in each individual case between voucher auctions and other forms of transfer (primarily sales to strategic investors and restitution to former owners), was decided centrally, but based on bids submitted from competing bidders and prepared by them with little government involvement. Thus, the design process was decentralized in a competitive framework, but the final decision process was controlled at the top. This approach, attractive both economically and practically, appears to have worked well in the politically centralized CSFR environment, where strong inside stakeholders were absent.

Poland and Romania (in its 1991 program) both attempted to follow a more centralized approach by giving the government broad powers to decide which firms would participate in mass privatization and how they would participate. While this was feasible in Romania, given the strong tradition of centralized power, it contradicted Poland's diffuse power structure. Indeed, managers and employees of Polish firms have maintained effective veto power over the choice of privatization method.

3. The Entry of Intermediaries

If ownership of enterprise shares were as widely disbursed as ownership of vouchers, there would be little likelihood of effective corporate governance. For this reason many mass privatization programs have encouraged the creation of intermediary institutions to pool ownership interests in particular enterprises. How they have approached the creation of intermediaries has differed, however. The former CSFR allowed free entry of fully private mutual funds, and over 420 funds participated in the first wave of privatization. These funds competed with each other to acquire vouchers from the public in exchange for fund shares. The funds then invested the acquired vouchers in shares of firms being privatized at auctions. One advantage of this approach was to reduce the state's direct control over the process, i.e. to "privatize" the privatization process.

In contrast, the Romanian (1991) and Polish mass privatization plans called for the top-down creation by the government of a certain pre-set number of investment intermediaries, staffed by managers chosen by the supervisory boards appointed by the government. The shares of the intermediaries were then distributed to citizens, with no auctions taking place. The hope behind this approach was that the intermediaries would actively restructure the firms in their portfolios and then sell their interests, in the form of "strategic" interests to core investors. While the objective has merit, the danger of such a top-down approach is that the intermediaries may not be subject to direct market pressures and could end up essentially as government-protected state holding companies. In Romania, for example, the single state ownership fund (SOF) was in 1991 allocated 70 percent of the shares of each commercial company in the mass privatization program, and was supposed to divest 10 percent of its holdings per year. Yet in four years it divested almost nothing, and the needed restructuring of firms in its portfolios barely began.¹⁹ Despite repeated statements that the program was on the verge of being launched, the Polish "top-down" approach did not get off the ground until 1995 (after a delay of three years), in part because—unlike in Romania—its centralized design was not in tune with the decentralized distribution of stakeholder power in the country.

¹⁹ The private ownership funds (POFs) were far more entrepreneurial than the state ownership fund (SOF). However, as the latter owned the majority interests in all participating firms, the power of the former was severely limited.

Although the free entry and competition among funds in the Czech Republic is arguably preferable to the bureaucratic approach of Romania or Poland, no approach has been without problems. It is proving to be extremely difficult in any transition setting to create truly private funds with market-based incentives. In particular, the perennial question of “who monitors the monitors?” looms over every experiment to date in mass privatization. This is a difficult enough challenge in advanced market economies. It is even more problematic in transition environments, where norms of disclosure and fiduciary responsibility are weak, and where “watchdog” institutions and oversight mechanisms are in their infancy. Breaking the links with the state, though perhaps desirable to stimulate entrepreneurship and risk-taking, also may mean weakening the capacity to monitor the monitors.

In the Czech Republic, as noted earlier, the largest funds were founded by and are still connected with the large Czech banks through asset management contracts. These banks in turn continue to be closely connected with the government, both through the sizable stake in the banks owned by the National Property Fund, and through the government’s regulatory powers over the banks. While some non-bank funds have quickly established their independence and their potential (if not always actual) influence over managers,²⁰ the bank-affiliated funds appear to be less independent and entrepreneurial. (There may also be some conflict of interest, to the extent banks lend to the same firms owned by funds they manage.) On the other hand, it may be that these larger funds are more accountable and may thus be more secure investments than the more entrepreneurial funds, which could perhaps have an incentive to “loot” an enterprise or take other actions at the expense of other shareholders. To the extent that several funds own shares in one firm, they have an incentive to monitor each other, making it more difficult for any one fund to engage in such “looting” barring collusion among the funds themselves. Although ownership limits arguably discourage active governance by funds over firms, the need to have several significant owners for cross-

²⁰ Although Czech investment funds routinely gain representation on boards of enterprises they own, numerous regulations dampened the incentives of the investment funds to invest heavily in active corporate monitoring and restructuring. These include, for example, the 20 percent limit imposed until recently on a fund's ownership of the shares of any particular enterprise and the rigid fee structure for fund managers that is not closely linked to the performance of the portfolio. The pros and cons of these and other specific regulations are discussed in Coffee (1996).

monitoring purposes may be one argument in favor of limiting the percentage of shares that can be owned by any one fund.

The Russian privatization program favored insiders (as noted above) but also allowed the free entry of private investment funds. Although some 600 funds were formed, they were kept much smaller than the Czech funds by the design of Russia's privatization program, and thus they have far less power and influence. In the Russian environment—with no legal safeguards, less macroeconomic discipline, and strong insider control over most privatized firms—the goals of the funds are always clear. Their small size leads may lead to complex coalitions among them or between them and other actors in the economy. Some funds appear to have been established primarily for short-term voucher trading, while others appear to be allied with incumbent managers of individual firms, and still others appear primarily to seek subsidies from government. Only some appear interested in owning and improving the performance of enterprises in the economy (Frydman et al, 1996).

In sum, intermediary institutions bring several advantages to voucher privatization programs. At a minimum they aggregate the power of individual vouchers and thereby exercise some monitoring functions associated with ownership. In addition to this minimum function, allowing free entry of intermediaries and keeping them independent of state ownership (either direct ownership or indirect ownership through other institutions such as state-owned banks) helps both to “privatize” the privatization process itself and to stimulate competition in the market for corporate control. Finally, some observers hope that the funds will become the cornerstones (perhaps together with existing banks or even in place of them) for the development of the financial infrastructure that is so essential for both capital allocation and corporate governance in market economies. However, achieving these goals is not easy or automatic. The weakness of general oversight capabilities (whether laws, institutions, information, or norms of conduct) in all transition environments exacerbates the inherent problem of “who monitors the monitors”. Careful attention must be given by transition governments as to how they might regulate funds or, more feasibly, encourage cross-monitoring among various funds or other owners to prevent self-dealing and encourage responsible fiduciary behavior on the part of fund managers. The involvement of foreign

financial experts as fund managers and advisors might help to strengthen norms of conduct within funds and encourage cross-monitoring among them. Interestingly, one potential advantage of the “top down” approach as designed in Poland is the ease of involving foreigners in fund management. Although foreigners may also become involved in a “free entry” system (and, indeed, in the CSFR case a foreign fund, Harvard Capital, was instrumental in selling the program to the public and ended up to be one of the largest funds), the involvement of foreigners is less of a policy lever at government’s command in such a setting.

4. Permitted Uses for Vouchers

Related closely to the size and role of intermediaries is the question of how citizens may use their vouchers. In the CSFR program, vouchers could be invested either in investment funds or in firms themselves. In the Romanian (1991) and Polish programs, in contrast, investing directly in firms was not an option. (In the newer 1995 Romania program, in contrast, investing in funds is not an option.) In Estonia, citizens could use their vouchers to acquire shares in firms (although relatively few shares were in the end offered for vouchers) or to purchase land or the housing in which they live.

There seem to be no obvious costs, yet significant benefits, to allowing wide latitude to investors. Options create competition that can spur funds to greater effectiveness. Furthermore, options force citizens to become actively involved in voucher investment and thus stimulate the development of investor interest and awareness. In addition, options allow investors to tailor their choices to their own personal risk preferences. While some people have preferred direct investments, funds have proven to be more popular investment vehicles than first expected. For example, in the first “wave” of the CSFR program, although original expectations were that most vouchers would be invested directly in firms, 72 percent of vouchers were ultimately invested in funds.

Furthermore, citizens’ choices need not be limited to investing their vouchers. Trading them is also a viable option, and permitting such trading may encourage the emergence of strong, interested owners from the very diffuse initial distribution of vouchers. If trading of

vouchers is not permitted, immediate rights to trade the shares acquired with vouchers is a close substitute. Most of the voucher schemes to date have given some latitude to citizens to sell their interests, whether in the form of vouchers or of acquired shares. Russia allowed voucher trading from the beginning. The former CSFR forbade secondary trading by citizens in voucher points (although this was not strictly enforced) but encouraged trading in acquired shares. Such trading has developed rapidly through the Prague and over-the-counter stock exchanges and through off-exchange transactions.

A somewhat surprising development in the Czech Republic has been the concentrated system of ownership and cross-ownership that has emerged from voucher privatization. Over 420 funds participated in the first "wave" of voucher privatization, (and 349 in the second wave), and some 72 percent (64 percent in the second wave) of vouchers were entrusted to those funds. Yet, the largest 13 funds obtained 43 percent of all vouchers (41 percent in the second wave). Not only is ownership of the economy concentrated in a few funds, but individual funds often own shares of directly competing firms. Furthermore, as noted earlier, the funds are themselves—together with affiliated banks—locked in an intricate web of cross ownership (or sometimes self-ownership) as a result of the privatization of the banks themselves through voucher privatization (Coffee, 1996). This web of cross-ownership not only tends to insulate banks from competitive pressures, but it also perpetuates government's influence over the Czech economy through its own 40 percent (or greater) residual holdings of shares in privatized banks. The Czech voucher privatization appears to have led so far to a rather tight concentration of ownership and economic power, dominated by the major banks, the government, and a few non-bank-affiliated private investment funds.

5. The Organization of Auctions

Market-simulating voucher auctions are used to allocate enterprise shares in most voucher schemes. Only in the top-down allocation models of Poland and Romania are they missing. There are two fundamental ways to organize voucher auctions: simultaneously or sequentially. CSFR (in the first wave) and the Czech Republic (in the second wave) followed a simultaneous approach, in which all voucher holders placed bids simultaneously for shares in

all firms to be included in the auction. The Bulgarian scheme proposed for 1996 follows a similar approach. Other countries (such as Georgia and Russia) have generally followed a sequential approach, auctioning firms off one by one. From an economic perspective the Czech model is more efficient, because all options are known to all bidders at the time of the auction, and the value (in terms of purchasing power) of a voucher does not vary over time as in the sequential model.²¹ However, it is also more complex and costly and may be infeasible in a larger country.

There are also two means to allocate shares within any particular auction. One, chosen in many countries because of its simplicity, is simply to divide shares on a pro-rata basis among bidders based on the number of vouchers put forth. The second, more complex approach, is to match bids against some independent measure of value and distribute shares only when bids and "offers" meet. The Czech approach was a modified version of the latter and used several rounds of bidding to equate demand and supply. Again, the result in the Czech case was arguably fairer but perhaps only feasible because of the relatively small size of the country, the relatively strong central control of the government, and the relatively sophisticated level of understanding in both the government and the citizenry. The Czech approach was also facilitated by the country's more stable macroeconomic situation, which meant that inflation was moderate and thus valuations of firms more meaningful.

6. Residual State Ownership or Control

Finally, voucher privatization schemes vary in the degree of residual ownership maintained by the state. Romania, for example, privatized only a minority (30 percent) stake in each enterprise through its 1991 voucher scheme; indeed, some observers question whether this was really privatization at all. While privatizing majority stakes, the Czech Republic,

²¹ Because the CSFR model used several rounds of auctions to equate supply and demand, as noted below, there was some variation in the purchasing power of vouchers between rounds. However, the variation was neither as pronounced nor spread over as long a period as in some other countries. In Russia, which held open voucher auctions after closed-subscription auctions had been held inside firms, the market price of vouchers rose and fell consistently and extensively over two years. Investors tried to weigh the number of outstanding vouchers against the value of firms yet to be offered for auction (whose very identity was constantly changing), and to incorporate into that their perceptions regarding the political sustainability of the process.

Poland, and Russia all left significant minority stakes in the hands of government property funds, with a view to using these stakes later to attract "strategic investors" (or otherwise influence events). The Polish government also has the initial power to appoint the managers and supervisory boards of the funds.

If the state is to maintain a stake in firms post-privatization, the stake should be small and temporary, and the state should maintain a relatively passive stance in governance.²² Extensive residual state ownership and/or control can lead to conflicts of interest that diminish if not nullify the hoped-for positive effects of voucher privatization, particularly if remaining ownership interests are widely dispersed and therefore passive (Pistor and Turkewitz, 1996).

III. SUMMARY AND CONCLUSIONS

This paper has reviewed the goals of privatization and has attempted to evaluate the various methods used in different transition settings to achieve them. The task is not merely one of changing ownership per se, but also involves a fundamental reorientation and/or creation of legal norms and supporting institutions to enable these new owners to exercise full ownership rights and corporate governance responsibilities. Experiments in privatization abound, from extensive efforts at sales to strategic owners (as in Hungary and Estonia) to programs based primarily on insider buyouts (as in Russia and Slovenia) to innovative mass privatization programs involving the creation of large and powerful new financial intermediaries (as in the Czech and Slovak Republics and Poland). These efforts are often complemented by extensive programs of restitution to pre-socialist owners and/or by smaller programs of bank-led debt-equity conversion or public offering of shares on newly-emerging stock markets. Each of these approaches has inherent advantages and risks, and in essence "the jury is still out" as to which will prove best in the longer run. At present, however, if the objective is to sever the links between the state and the enterprise and school the population in market basics, the weight of initial evidence appears to point in favor of

²² This does not mean that governments should ignore governance altogether. At a minimum, they should continue to monitor in order to prevent fraud and asset-stripping.

significant reliance on voucher privatization, particularly given the difficulty most countries face in finding willing cash investors. Among voucher privatization programs certain design characteristics appear to simulate beneficial competition and a market for corporate control:

- free entry of financial intermediaries,
- freedom of investor choice (whether in firms or in intermediaries) and immediate free tradability of shares (and perhaps even vouchers),
- as few insider preferences as feasible (given the distribution of preexisting political power among stakeholders), and
- little if any residual state ownership, *but* early and strong attention to the critical government tasks of:
 - developing legal norms of fiduciary responsibility, legal remedies to enforce them, and “watchdog” institutions to implement them,
 - encouraging ownership patterns that promote both competition among firms and corporate governance both of firms and of intermediaries (perhaps, for example, by preserving some degree of ownership for “strategic investors,” by limiting individual funds’ stakes to encourage cross-monitoring among funds, or by imposing strict antimonopoly regulations), and
 - encouraging the development of stock markets to promote the further evolution of ownership.

This is to a significant extent—though not entirely—the Czech model of privatization. In particular, the Czech case differs along the fourth criterion noted above. Not only have disclosure and oversight capacities over funds (and to some extent firms) been weak, but the concentration of ownership and control over much of the economy -- primarily in the hands of a few funds and large banks, and to a significant extent the government through these other two, and through its own significant residual holdings -- is cause for concern.

A final lesson from experience is that formal programs of enterprise privatization are only part of the picture—and often only a small part, although they have received most of the attention. A process of asset “recombination” of property is occurring, often behind the scenes, throughout the transition world, whether a “recombination” from state to private firms

(Stark, 1996) or from some private firms to others (generally from private firms that are more widely-held, either directly or indirectly through funds, to more closely-held ones). Extensive privatization is thus in fact occurring even in countries where formal privatization has been slow (such as the Ukraine or Bulgaria), and extensive “recombination” may be likely even in countries where it has been fast. In the Czech Republic, for example, not only will the ownership both of enterprise shares by funds and of fund shares by individuals change through formal and informal trading, but the ownership of enterprise assets may themselves shift to some extent as owners (particularly certain funds) or managers sell or spin off assets into new companies. In Russia, this shifting of assets to new, more closely-held firms may be quite widespread, as managers with small minority ownership stakes in newly-privatized firms attempt to gain greater control over assets. As one Hungarian observer noted, this is the period of “primitive capital accumulation” in the post-socialist world. Although formal programs may lay important groundrules, the tremendous economic, legal, political, and even moral uncertainty profoundly affect—and may even overwhelm—most formal efforts at privatization. It is beyond our ability or insight to know what the final outcome will be. Both the economic outcomes of these various paths and our efforts to assess them are just beginning to yield insights, and it will be years—if not generations—before a definitive story can be told.

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