The United Nations University
WIDER
World Institute for Development Economics Research

Working Papers No. 146
February 1998

Privatization in the Countries of Eastern and Central Europe and of the Former Soviet Union

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February 1998

This study has been prepared within the UNU/WIDER project on Transition Strategies, Alternatives and Outcomes, which is co-directed by Professor Giovanni Andrea Cornia and Professor Vladimir Popov.

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Camera-ready typescript prepared by Lorraine Telfer-Taivainen at UNU/WIDER
Printed at Pikapaino Paatelainen Oy, Helsinki

ISSN 0782-8233

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ACKNOWLEDGEMENTS

The author gratefully acknowledges the research assistance of Mr Panu Kalmi, and the comments of the participants at the project meetings held in Helsinki in November 1996 and May 1997.

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Helsinki, February 1998

ABSTRACT

In transition economics, privatization seems to have two basic motivations: separation of politics from the economy, and better corporate governance. While different countries have emphasized such motivations to varying degrees, it is clear that none of the privatization methods chosen is indisputably the best. Also, it has proved impossible to plan privatization in the sense that the emerging distribution of property rights has been virtually always different from the one that the authorities seem to have had in mind. Evidence of the comparative productivity impact of different privatization paths is still too fresh to allow for a final assessment. Neither do we know whether the transition economies have been basically locked into their now existing property arrangements or whether efficient markets for property title will lead to a more optimal distribution of such rights.

'And naturally, current state capitalism is not of my liking, but it is something different from the previous socialist system'. Yegor Gaidar (Segodnya, 24 October 1996)

'The goal of privatization was to sever the dependency between enterprise managers and politicians, but the tie proved more durable than many observers had believed or hoped'. Joseph Blasi (Blasi *et al.* 1997: 30)

I INTRODUCTION

Some 6,800 enterprises were privatized in the non-transition economies of the world between 1980 and 1991. In contrast, more than 45,300 large- and medium-sized firms were divested in the transition countries of Central and Eastern Europe and the former Soviet Union by the end of 1994. More have been privatized since. Furthermore, several hundreds of thousands of small businesses have also been privatized. There has also been an explosive growth in new private activities. Overall, an 'incredibly large and rapid shift of ownership has taken place in this region' (Nellis 1996).

Still, privatization is not complete. Post-socialist countries quite typically still have a quarter or a third of the industry still in public ownership. Privatization of agriculture has usually not progressed in countries were collectivization took place more than a generation ago. Only a few countries have privatized a sizeable part of the infrastructure. And in many cases governments still maintain significant percentages of shares in privatized enterprises. In some cases, these blocks will be privatized later on. In others, governments want to maintain their influence permanently.

In economics, privatization was traditionally analysed as a matter of somewhat marginal adjustment within the framework of a generally well-functioning market economy.[1] A pragmatic consensus evolved: privatization is neither necessary nor sufficient for efficiency but often contributes towards it especially by facilitating competition in the activities involved. In the process of post-socialist transformation, the scholarly emphasis shifted. It has been often argued that privatization in the

[1] Basic analyses of privatization in market economies include Bos (1990), Vickers and Yarrow (1988, 1991) and for the developing countries, Bureaucrats (1995).

transition from plan to market is somehow more fundamental than just a redefinition of selected property rights. It is seen as a crucial part, even as the essence, of creating the wider framework for the market mechanism.[2]

Historically oriented analysts will debate whether privatization was in the transforming countries advocated for the right reasons or not. The fact remains that privatization has in practice been seen as being necessary, though not sufficient for the transition. For this paper, it is sufficient to distinguish between two interconnected but different underlying economic reasons for privatization in transition. The first one is separation of political and economic decision making, and the second improvement of corporate governance.

Though some disagreement still remains, a strong case can be made that socialist economies proved inefficient because of the basic Marxian goal of ending the separation between the economic and political spheres. This split society syndrome - Smith's need for the invisible hand - was rightly diagnosed as a feature of the bourgeois society differentiating it from earlier social systems. The goal for the aimed-at future society was to regain a system were human lifespheres would again become one, unalienated from one another. Man should become the master of his life. The alien laws of the economy should be substituted by conscious action jointly co-ordinated. In practice, the split in the social organism was to be remedied either by introducing something characterized as social property - in Yugoslavia - or property primarily by the state and secondarily by other political institutions. The perhaps partly unintended but certainly devastating consequence was that all too many economic decisions were made on political grounds. Post-socialist privatization can, in this view, be seen as a return to a split society, where most economic decisions should be made on the economic grounds of maximizing expected asset values. Firms should not be dependent on the state; the state should have reduced influence on firms; the economy should be depoliticized (Frydman and Rapazcynski, 1994; Boycko, Shleifer and Vishny, 1995).

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[2] Literature on post-socialist privatization fills libraries. For influential early analyses see, among others, Blommestein and Marrese (1991), Borensztein and Kumar (1991), Gelb and Gray (1991) and Lipton and Sachs (1990). Overviews include Bornstein (1994, 1996), Estrin (1996), World Bank (1996), Desai (1995), Gray (1996), Lavigne (1995), Gros and Steinherr (1995), OECD (1995) and many others.

In this view, privatization is seen as the only credible way of doing away with the soft budget constraint by cutting the patriarchal umbilical cord between production units and the state. Privatization is, thus, basically a credibility-creating mechanism; by privatizing, the state precommits itself in a hopefully credible way to consistent withdrawal from the economy.[3]

If this basis for privatization is seen as the fundamental one, the speed and width of privatization tends to become the basic goal. The actual methods of privatization are then of less importance than the goal of separating the state and the economy.[4] Getting the state out is primary; who the new owners are is secondary. Often, this attitude is complemented with a trust in the Coase Theorem: the view that the original distribution of (private) property rights does not really matter as soon as secondary markets in property titles are functional. They will lead to an efficient distribution of property rights.[5]

Another view also exists. On this interpretation, privatization is basically a method of improving corporate governance. In actual socialism, property rights were badly defined. 'The state' is an entity that hardly exists, and different groups of people had at least some such stake in productive units that can be seen as amounting to *de facto* if not *de jure* property rights. Among them are the political decision makers, the planners, industrial ministries, regional and local authorities, managers and the work force. With unclear property rights - sometimes dubbed 'nobody's property' in socialist reform economics - incentives of economic agents were also unclear. The practice of socialist economic reforms had not found a credible and workable way of redefining socialist property rights so that the preconditions of efficient corporate governance would have emerged. By 1989-90 the willingness to risk further socialist experiments no longer existed in Central and Eastern Europe. Thence transition and privatization.

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[3] For a theoretical analysis along these lines see Riechmann (1996).

[4] As two Czech economists explain: '... the underlying philosophy of the Czech privatization program (is) that any (other) owner is better than the state. Even if some enterprises remain without effective owners for some time, the implications for managerial bahavior are not necessarily worse than if the enterprise remained in state ownership.' Joshua Charap and Alena Zemplinerova as cited in Bornstein (1996: 26).

[5] Coase (1960); for a critical analysis see Stiglitz (1994).

Compared with the first fundamental reason for privatization, the second one will probably lead to greater attention to the methods and schedules of privatization. Though any private property is in principle equally distant from the state, different sets of private property rights clearly differ in their potential for efficient corporate governance.

These fundamental economic reasons for privatization in transition are clearly interconnected. Other possible rationales for privatization have also been discussed. Some of them are basically arguments for proceeding fast with privatization: the need to compensate the population for declining income and increasing uncertainty; the wish to mop up part of monetary overhang; the need to prevent asset theft by managers and others; and the wish to free the state from such tasks as asset maintenance and control which it simply cannot perform. Other reasons are based on the economic particularities of the countries concerned; the need for budget revenue or resources for servicing foreign debt are among them. And finally, there are quite obvious ideological and political reasons, and issues of justice have been also often cited, in particular concerning some of the non-standard privatization methods. Thus, restitution of property to pre-socialization owners may, independently of any economic considerations, be regarded a matter of binding positive fairness. A past wrong-doing should in this view be alleviated through privatization. At the same time a historical continuity is emphasized. Or restitution may also be regarded a matter of negative justice, a way of preventing future wrong-doings by limiting privatization participation to those residents that are not imports of the socialist regime.

Overall, the two fundamental considerations for privatization were probably of greater importance in choosing between different privatization methods than deciding whether to privatize or not.

An economy dominated by the private sector can come into being in two ways. The first one is privatization of previously existing state- or socially-held production facilities. That is the topic of this paper. The second path to a privately-dominated economy goes via newly created private enterprises, especially but not only in previously repressed activities like many services. The latter path is at least as important as privatization. Given the need for structural adjustment and senile industry considerations, new private enterprise may prove more important for economic growth than anything that takes place in inherited facilities. This dynamism is also dependent on state sector adjustment, not least of all due to the need for resource mobility to the growth sectors. Indeed, many seemingly *ab novo* enterprises are actually more or less legal spin-offs of state-owned enterprises. This paper does not discuss new private sector development, important as it is.

Neither does this paper discuss the necessary and actual adjustment of remaining public sector enterprises. Several examples (especially but not only from Poland) show that change in environment and incentives does have an impact on the behaviour of state-owned enterprises. The stronger the state and the more capable its administration, the better are the possibilities for state-led enterprise adjustment. Neither is state capability an exogenous variable - but discussing that is outside the scope of this paper.

The rest of the paper is divided into chapters. The second chapter outlines the opportunity costs of different privatization methods. There is no unique optimal privatization method, and existing alternatives together with initial conditions and political factors explain why each country chose the particular mix of privatization paths that was adopted. The third chapter offers an overview of privatization experience in Central and Eastern Europe and the countries of the former Soviet Union. To decrease the number of cases to be covered, the emphasis is on the Czech Republic[6], Hungary, Poland, Estonia, Lithuania and Russia. The fourth chapter points out some of the divergencies between actual privatization outcomes and initial plans in different countries to draw a more general conclusion: privatization could not be planned in detail. The fifth chapter asks, using the Russian example, whether initial outcomes can in all cases be expected to be the starting point of an evolutionary process leading over time to an efficient distribution of property titles. Chapter six, finally, offers some tentative conclusions.

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6 In addition to various overviews and country studies, particularly by international organizations like the IMF, the World Bank, the EBRD and the OECD, the rich privatization literature concerning each of the countries has been consulted. It is too numerous to be enumerated in total. Several country studies are collected in Estrin (1994) and in Frydman, Rapazcynski and Earle *et al.* (1993ab). Central additional references include for the Czech case, Kotrba and Svejnar (1994). For Hungary, Voszka (1993); for Poland, Gomulka and Jasinski (1994) and Kalmi (1995); for Russia, Bornstein (1994), Lainela and Sutela (1994), Boycko et al (1995). For Estonia, Purju (1996) and for Lithuania, Maldeikis (1996).

Through the article, the emphasis is on the privatization of medium- and large scale state-owned industrial enterprises. The small scale privatization of retail trade, service establishments and workshops is a relatively straightforward matter, as capital needs are small, entry to markets often easy, and the prospect of better choice and quality to consumers immediate. The need for restructuring and new entry differed across countries, as did the degree of preference given to insiders in privatization. But overall, small scale privatization has been both easy, popular and beneficial.

Farm privatization is both more complex and varying across countries. In Poland, most agriculture was never collectivized, while in most of the former Soviet Union collectivized agriculture still remains, though often under a different legal label. The countryside is often very resistant to change, perhaps because the old regime was in spite of low living standards often lenient relative to available resources. Still, a market in land would be a high priority from the points of view of resource transfer, business entry and the use of collateral. This is true of commercial real estate and housing as well. None of the transition countries seems yet to have a systematic programme of privatizing commercial real estate. The situation concerning housing privatization varies across countries. Bank privatization has peculiarities also not discussed here (see Kormondi & Snyder, 1996).

II TRADE-OFFS IN THE CHOICE OF PRIVATIZATION METHODS

The current orthodoxy on post-socialist privatization is offered by the World Development Report (1996: 50-56). The World Bank concludes that privatizing medium and large scale enterprises has proved much more difficult than originally thought. The goals of privatization may be complex and are often conflicting. *De facto* property rights are claimed by a number of stakeholders who have to be satisfied. As a lengthy or postponed privatization process as such creates uncertainty - and may trigger off profit shifting, tax evasion and asset looting - speedy privatization is to be preferred, especially when state capability is insufficient for controlling incumbent managers and also for possibly restructuring state-owned assets. But fast and wide privatization is administratively demanding, especially where mature capital markets do not exist and a central role of foreign investors is resented. The Report concludes that approaches to privatization have abounded and each approach has created trade-offs among various goals. Table 1 is based on Table 3.1 in the Report. This table is a generalization of the experience of the past few years, but fundamentally its judgement is well in line with the *a priori* speculations of years 1989-90.

TABLE 1. TRADE-OFFS AMONG PRIVATIZATION ROUTES FOR LARGE COMPANIES

Objective Method	Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outsiders	+	-	+	+	-
MEBO	-	+	-	?	-
Equal-access vouchers	?	+	?	-	+
Spontaneous privatization	?	?	-	-	-
Russia	-	+	-	-	-
Restitution	-	?	-	-	?

Source: World Bank (1996) *World Development Report: From Plan to Market* – author's adaptation of Table 3.1.

The World Bank distinguishes between three major privatization methods. There have been direct sales of various types, either by negotiated trade sales (as in Hungary), or by bunching companies in a tender (as in Estonia and Latvia), or by a public offering for shares (as in Poland). Second, there have been management buyouts (MBO) and management and employee buyouts (MEBO). This may take place in an open competition (as in Czechoslovakia and Estonia), without competition (as in Russia under World Bank interpretation) or with privileges offered to insiders (as in Latvia). Finally, there have been equal access voucher privatizations, where the public is distributed free or at a low price vouchers that can be exchanged for shares in enterprises or investment companies (as in Czechoslovakia). This method is often called mass privatization.

Table 1 differs from the Report's table in a few respects. First, the World Bank regards Russian insider privatization as a form of MEBO. This is controversial. True, in Russia most privatized assets did end up being owned by enterprise insiders. As the transfer was for practical purposes free of charge, the Russian case however differs from a typical MEBO. In Table 1 it is regarded a special case, scoring four minuses and only a single plus on speed and feasibility.

The World Bank table also lacks restitution of assets to former owners as a privatization method. That has been added to Table 1. It clearly scores minuses in all columns with the possible exceptions of question marks in the second (speed and feasibility) and fifth (greater fairness) columns. In some kinds of property, restitution has clearly been feasible. It would only have been speedy if unambiguous restitution claims could have been backed up with unambiguous property registries. This was never the case.

Some of the trade-off assessments given in the table are naturally open to debate. This is notoriously so of the fifth column (greater fairness) due to the intrinsic impossibility of reaching agreement on what is fair. Largely, however, the assessment on fairness in Table 1 follows that of the World Bank table, though a MEBO might well be given at least a question mark here. Concerning MEBO, the World Bank minus in the fourth column has been changed to a question mark. A proper MEBO might, after all, contribute towards government revenue, at least when credits are available either in the market or from the state.

These and possibly other considerations notwithstanding, Table 1 should drive home two basic messages. First, several privatization methods are obviously available. Second, the choice between the available methods is complicated by the fact that none are unambiguously better than the others. Sale to outside owners scores the largest number of pluses, but it also has two serious minuses. MEBO has only one plus, but that may be a crucial one under some circumstances. Equal-access voucher privatization does not bring government revenue, but is regarded as fair and fast. The other properties of this previously untested method are open to doubt, and even speed might be questioned, depending on the requirements set upon voucher privatization. Spontaneous privatization seemingly has little to recommend itself.

Taxonomies of privatization methods can be specified further. Thus, Estrin and Stone (1996) assess the mass privatization programmes of nineteen transition countries using four criteria:

- Are shares issued in waves or continuously?
- Are vouchers used bearer or registered, tradable or nontradable?
- What is the attitude adopted towards private investment funds?
- Is the fund's management in independent companies or self-managed?

They derive five models of mass privatization: the Russian, Armenian, Lithuanian, Czech-Slovak and the Polish.

III THE CHOICE OF PRIVATIZATION METHODS

This section describes the choice of privatization methods in different countries of Central and Eastern Europe. Table 2 (reproduced with the deletion of data for Mongolia from the *World Development Report: From Plan to Market,* 1996) outlines the relative weight of different methods in six selected countries as of the end of 1995.

Naturally, not all the information in the table is beyond doubt. As pointed out, classification of privatization methods can be tricky. In some countries, Lithuania in particular, relevant information is either totally missing or lacking in trustworthiness. Thus, a knowledgeable Lithuanian analyst (Morkunaite 1996) cites unspecified official information claiming that the share of voucher privatization was actually only 35 and not 60-70 per cent of all state-owned assets. Buy-outs and other methods account, according to this information, for 15-30 per cent of assets. This would leave 0-25 per cent of assets still in state hands. Such figures differ clearly from the ones given in table 2.

Neither can the table be used as an index of the relative size of the state sector. It only purports to show which part of the number and value of former state assets have been privatized and how. But as will be discussed below, the distinction between public and private spheres may be impossible to draw exactly, as cross ownership is frequent in many countries. And when one asks, for instance Russians, in which sector they work the answer is surprising. The combined state sector, including both the budgetary and state enterprise spheres, still accounted in April 1995 for the majority of Russian employment: a total of 56.7 per cent. Only 28.8 per cent report that they work in privatized entities, and a mere 12.5 per cent in the new private sector (Earle and Rose, 1996ab). Meanwhile the World Bank reports that Russian private sector produced in 1995 60 per cent of the GDP in the country (World Bank 1996: 15). Naturally 40 per cent of employees may produce 60 per cent of GDP, but it is also possible that employees really do not know the property arrangements of their jobs. If so, we have additional indirect evidence on the lack of restructuring in privatized Russian industry.

TABLE 2. METHODS OF PRIVATIZATION FOR MEDIUM AND LARGE SIZED ENTERPRISES IN SEVEN TRANSITION ECONOMIES (PERCENTAGES OF TOTAL, END 1995)

Country	Sales to outsiders	MEBO	Equal-access vouchers	Restitution	Other	Still in state hands
Czech Rep.						
by number	32	0	22	9	28	10
by value	5	0	50	2	3	40
Estonia						
by number	64	30	0	0	33	22
by value	60	12	3	10	0	15
Hungary						
by number	38	7	0	0	33	22
by value	40	2	0	4	12	42
Lithuania						
by number	<1	5	70	0	0	25
by value	<1	5	55	0	0	35
Poland						
by number	3	14	6	0	23	54
Russia						
by number	0	0	11	0	55	34

Source: World Bank (1996) *World Development Report: From Plan to Market* – author's adaptation of Table 3.2.

Note: Russian privatization regarded MEBO by the World Bank has been here reclassified as 'other'.

3.1 Sale to outside owners

Sale to outsiders was often regarded as the natural privatization method during the early period of transition (Bolton and Roland 1992). Previous privatization experience from such countries as Britain and Chile served as a model and technical advice was easily available, even if at a cost that sometimes proved to be high. In fact, all the countries chosen for analysis here used sale to outside owners to some degree, though that was almost negligible in Lithuania and quite small in Poland. Russia, which scores zero on this privatization method in Table 2, embarked in 1995 upon a loans-for-shares programme to be discussed below. It should be seen as a form of sale to outside owners. But the overall experience has been rather more modest than expected. Though corporate governance has improved, this has been a slow, difficult and costly method.

The objectives of sale to outside owners, as enumerated in Table 2, include better corporate governance, better access to capital and skills and more government revenue. On the other hand this method scores negatively on speed and feasibility as well as on greater fairness. The ability to reach these and other objectives also depends on the method of sale chosen; initial public offerings, auctions, public tenders and direct negotiations with buyers are among the alternatives.

It is generally assumed that sale to outside owners is good for corporate governance for two main reasons. Having used own resources to acquire assets, owners should be motivated to use resources and to monitor managers efficiently. Excessive ownership dispersion could be easily avoided. The experience so far clearly tends to support these conclusions.

Sale to outside owners may be slow or unfeasible for several reasons. Prospective domestic buyers might not have sufficient capital, especially after high inflation released by price liberalization, or any available capital might have been accumulated through activities disapproved of by the authorities or the general public. Finance for potential buyers may not be available from underdeveloped or non-existing capital markets. Foreign investors may not be available, they may be dubious, or their role may be worrisome in view of existing nationalist feelings. Nellis (1996) offers a rough estimate that from 10 to 15 per cent of all enterprises up for privatization in transition economies will prove attractive to monied core investors. The appropriate price of assets is difficult to assess as the productive establishments in question have no proper market valuation and uncertainty on future profit flow is high. The state may want to increase its revenue by prior restructuring of plants, which slows down sales and may even prevent them for a long time for lack of money and expertise for restructuring. Existing property rights are unclear because of numerous stakeholders, and they need to be clarified and stakeholders satisfied before sales can proceed. Stakeholder privileges may on the other hand scare outside investors. This is also true in view of the implicit employment, environmental, social asset or local activity liabilities that the plants to be privatized may have, and which may originally come as a surprise particularly to foreign investors. Sale helps to create but also necessitates the existence of such markets and financial services that were not previously available.

On the other hand, sale to outsiders should give better access to capital and proven skills, especially when sale is to foreign buyers who might also bring technologies and market access with them. The fiscal impact of such privatization is dependent on prices adopted. In practice, direct privatization income in the Czech Republic, Hungary, Poland, Estonian and Lithuania in 1991-95 was insignificant or small (Table 3).

TABLE 3. DIRECT PRIVATIZATION INCOME IN THE CZECH REPUBLIC, HUNGARY, POLAND, ESTONIA AND LITHUANIA IN 1991-95 (A = PER CENT OF GDP, B = PER CENT OF BUDGET REVENUE)

		1991	1992	1993	1994	1995
Czech Rep.	A		3.29	2.64	3.22	n.a.
	B		6.95	5.30	6.61	n.a.
Hungary	A	1.22	2.30	3.80	0.74	n.a.
	B	2.35	4.12	7.10	1.43	n.a.
Poland	A	0.20	0.40	0.50	0.80	1.17
	B	0.80	1.50	1.70	2.50	3.20
Estonia	A	n.a.	n.a.	0.40	0.40	0.50
	B	n.a.	n.a.	1.50	1.60	0.80
Lithuania	A	n.a.	n.a.	n.a.	0.50	0.30
	B	n.a.	n.a.	n.a.	1.80	1.10

Source: for the Central European countries, Antczak (1995); for the Baltic countries, Niina Pautola, Unit for Eastern European Economies, Bank of Finland.

In the Czech Republic, sale to outsiders has not been the major privatization method, as it only accounted for 5 per cent of privatization by value although as much as 32 per cent by number. There was no major budget balance problem, and the country inherited almost no foreign debt to be serviced. In addition, there was a widely-shared historically based cautiousness of allowing major foreign ownership in the country. Because of geographical location and historical tradition such inflow might actually have been forthcoming. These reasons contributed to the selection of voucher privatization as the major privatization method. Because of the lack of socialist reforms in the country, non-state stakeholders only had very limited *de facto* property rights to be compensated. This also facilitated the choice of mass privatization (Frydman and Rapaczynski 1994).

Against this background, it is somewhat surprising that Czech privatization revenue has been relatively the largest in Central Europe. It is not directly budget revenue, but flows to the National Property Fund, which uses part of the revenue for investment. Ironically, the fact of voucher privatization may actually have indirectly increased fiscal revenue from privatization by sales in four ways (Antczak 1995). The wide dispersion of voucher-acquired shares creates the need and possibility for controlling bids; voucher privatization was serviced by a large amount of investment-relevant company-level information; the development of secondary markets through voucher privatization enhances share prices and thus privatization revenue; and voucher privatization created an encouraging irreversibility of systemic change.

Sale to outsiders has been the major privatization method in Hungary, the only developed post-socialist country without a mass privatization programme. Already in the late 1980's, managers were able to construct webs of interlocking company ownership often combining public and private parties. In many cases, actual ownership became, and still remains, nontransparent. Negotiating procedures chosen by the authorities contributed to the lack of transparency (OECD, 1995b). In 1989, 1876 firms were transferred to the State Property Agency, and the period of formal privatization followed. In five years (1990-94) Hungary was able to transfer only about one-third of its state-owned assets to private hands through formal sales programmes (Pistor and Turkewitz, 1996). The bankruptcy or liquidation of firms together with transfer of companies to other state agencies were actually more important in shedding the Property Agency portfolio. Extensive direct and indirect state ownership remained, though that has recently diminished with infrastructure privatization. Still, the Hungarian fusion of state and private ownership has raised questions about 'the logic and implicit commitments of these holdings' (OECD, 1995b: 115). The government has repeatedly saved enterprises in financial distress. The goal of financial discipline has thus been undermined.

Seen against the deficit problems of the country, the amount of fiscal revenue from privatization has been quite modest. In 1995, however, due to large scale infrastructure privatization, revenue rose to 7.5 per cent of GDP. Asset sales have been relatively better at raising foreign than domestic capital. In 1995, four out of five privatized companies were in foreign hands, and 64 per cent of privatization revenue has been in foreign currency. Hungary has been a relatively large recipient of foreign direct investment. Privatization has contributed to such inflow, and this is seen as a major benefit of the method preferred. On the other hand, about two thirds of foreign investment is due to greenfield development. Though selling infrastructure enterprises has proved difficult (Mihalyi 1996), Hungary is now together with Czech Republic and Estonia one of the few countries that have succeeded in privatizing a large part of this core of socialist assets.

Poland's slow and hesitant privatization is reflected in the fact that as the end of 1995, the majority of socialist enterprises were still in state hands. This contrasts with the original expectation that by 1994 the proportions of assets publicly and privately held would be similar to those found in well-established market economies (Blasczyk 1993: 16). Only a small number of plants - at most about 200 by direct sales and some 30 through the stock exchange - had been sold to outside owners and the fiscal revenue flow was decidedly minor. There was a slight increasing trend in revenue in 1991-95, but probably no reason to expect it to continue. In Poland, employee resistance to sales has been a major problem, especially when potential foreign investors have been involved. But probably the biggest stumbling block has been Polish willingness to plan almost any privatization well in advance. Detailed privatization plans have often stuck either in wide-ranging scholarly and public debate, or in the process of political decision-making and implementation.

Polish privatization may have been simplified by the August 1996 privatization law. Commercialization (corporatization) of the enterprise need no longer have the acceptance of both the management, employee council and employee general meeting. Commercialization without an immediate plan for privatization is now also possible, and this is seen as crucial for the governance of remaining state assets. And, finally, because commercialized enterprises will not have an employee council, the role of the state as the owner will be stronger. In privatization, the emphasis will be on individualized sales to raise revenue, in particular to fund the impending pension reform (Kolodko and Nuti 1997). This will continue the Polish commitment to slow privatization (OECD 1996b: 69-70).

In Estonia, the large share of foreign citizens among the industrial labour force in fact made it impossible to use a privatization method favouring enterprise insiders. For a small country in the geographical and cultural proximity of the Nordic countries, foreign capital was deemed an available necessity. Coming to this conclusion took, however, some time. The first privatization law of 1990 was based on sales (Purju 1996). In 1991, however, another law was passed stipulating restitution and the use of vouchers as the main privatization tools. This was in reaction to the feared central role of foreign capital and mafiosos in sales-based privatization. The emphasis on restitution bogged down privatization, and spontaneous privatization and decline in asset values soon forced another sharp change in strategy. In addition, the introduction of the currency board probably helped to tilt the scales in favour of sales-based privatization. As domestic money supply became endogenous, maintenance of capital inflow was a necessity, and a 1993 legal amendment re-emphasized the role of sales. A Treuhand-type privatization agency was formed with German advice and financial support. A single effective owner was always aimed at. Bids were awarded not only on the basis of price, but business plan, investment and employment guarantees were crucial as well. It was further decided that half of net privatization revenue would be earmarked for compensating former owners of nationalized properties in cases where restitution is not feasible. The other half is divided between property reform related government expenses, pensions and labour education. No direct budgetary revenue was thus planned for. In 1996, the division of privatization revenue was somewhat changed, but the previous principle remained.

In practice Estonia has run separate local and well-advertised international tenders for a number of enterprises at the same time. Foreigners could also participate in local tenders. Altogether, 373 enterprises were offered in ten tenders, and by the end of 1995 about two thirds of them were sold partially or wholly in a total of 347 purchasing contracts (Purju 1996). The aggregate value of these contracts was 2.1 billion EEK (about US$200 million). In terms of speed, Estonian privatization has been a great success after it got started. Though a large number of state and municipal enterprises are still registered, very few among them remain active. The privatization of only 50-60 wholly or partly state-owned firms is still planned. The most important among them are infrastructure enterprises, several of which should be privatized in near future. Basically, Estonian medium and large scale enterprises are already private. In perhaps two-thirds of cases, the new owners are enterprise outsiders.

Revenue raised by privatization is a different matter. As just seen, it has been meagre at best also in Estonia. In a Treuhand manner, purchasers also take over existing enterprise liabilities, notably tax arrears, and make investment commitments. In some cases, the actual purchasing price has been one EEK. On the average it is estimated that tax and other debt obligations accepted about double the value of accepted bids. Furthermore, in most cases only one fifth of the price is paid immediately, and the rest in instalments up to ten years. The interest rate added has so far been clearly negative in real terms. This further decreases privatization revenue.

The interest of foreign investors has been quite strong though probably less than originally expected. In ten tenders, a total of 961 bids were received. Of them, 200 were openly foreign, and some others probably had a foreign background also. Perhaps 40 per cent of concluded deals include foreign interests. In some cases - like the Viru Hotel, a Tallinn landmark - foreign investment through Estonian middlemen has raised a political storm. Neither are all foreign experiences of the Estonian environment merely positive. Important additional foreign investment is expected for infrastructure investment.

Lithuania's ambitious privatization programme was in 1992-96 based upon the use of vouchers. Of some 6,500 enterprises included in the programme, about 5,700 were privatized by October 1995. Only 42 enterprises were sold for cash. The authorities have long planned for a second sales-based phase of privatization, but it has been repeatedly postponed.

3.2 Restitution

Restitution, the return of nationalized properties to former owners or their descendants, was excluded in most of the former Soviet Union during the socialist period. In Czechoslovakia, Poland, Hungary and the Baltic countries the arguments in favour of restitution were basically similar. Restitution was advocated as a way to redress past injustices, as a way to restore public confidence in private property rights and as a simple and quick way to privatize some properties. In some countries support for restitution became a political issue. In the Baltics, restitution was also a way to emphasize the continuity of statehood only interrupted by Soviet occupation. In addition, restitution was a way to minimize the role of Soviet-era immigrants in privatization.

The arguments against restitution were both ideological, economic and practical. Ideologically, the fairness of restitution could be challenged, as most citizens would not be compensated for the injustices suffered under socialism. Economically, restitution of assets that might be sold is a fiscal loss. Neither is it obvious that former owners are always effective owners. Practically, it was argued that any decision on what to restore and what not, is always arbitrary. And because ownership claims are often unclear, restitution would become a lengthy process slowing down privatization as a whole (see the overview in Bornstein, 1996).

Of the three Central European countries, the Czech Republic had the strongest restitution programme. Restitution was not a part of the government's original privatization plans, but was added to them by the parliament. The cut-off date in Czech restitution is February 25, 1948, thus excluding the assets nationalized by the democratically elected government in 1945-48, the property of the Sudeten Germans expelled in 1945-46 and the Jewish property confiscated after 1938. Restitution only applies to physical assets returned to their original owners or to their descendants. Financial compensation is an exception. As a general rule only physical Czech citizens residing in the country are eligible, though buildings have been returned to the Catholic Church. Whether the church should be compensated even more has proven a hot political issue.

Another problem area in Czech restitution is agriculture. Records are incomplete, and the principle of physical restitution is difficult to apply when land use and values have changed much. Altogether, restitution may have covered almost 10 per cent of former state properties, and the proportion may have risen as high as a quarter of state-owned apartment housing and retail shops. As Table 2 shows, the share by value of assets privatized this way is quite low. But basically the restitution programme has been implemented.

In Hungary, restitution was not only long debated politically, it also became an issue of legal interpretation in three aspects. After an intervention by the Constitutional Court, the cut-off date in Hungarian restitution was shifted from 1949 to 1939. Originally, pressure for restitution came from agrarian interests, but again the Constitutional Court ruled that all land, buildings and equipment must be covered. In addition to physical citizens residing in the country, religious and charitable institutions are eligible. The Court finally decreed that all compensation should be either physical or financial. Practical considerations led to the choice of financial compensation. This has clearly simplified restitution.

In addition to nationalized property, compensation can also be based on such non-material injuries as death or imprisonment. With the exception of the very smallest damages, compensation is partial with the cap equivalent to less than US$7,0000. Compensation is paid in tradable certificates that can be used to buy specific assets and shares, agricultural land, apartments and life annuities. Because the Hungarian government prefers privatization through cash sales, insufficient and often poor-quality assets have been available for restitution certificates. Consequently, the market value of certificates has dropped dramatically, by some 80 per cent from the sum of face value and capitalized interest. Hungary has failed to implement her restitution programme.

Poland has been unable to decide upon a restitution programme. There has been no clear political will in favour of restitution. Because agriculture was decollectivized in 1956, even the usual agrarian interest for restitution does not exist. The Polish government has been less than enthusiastic about a form of privatization that would deprive it of fiscal revenue. Not only has the debate failed to lead to a clear conclusion, it has also been quite undetermined. The eventual cut-off date is undecided, and neither is it clear whether the scheme should cover all nationalizations or only those in conflict with prevailing legislation. Indeed, there is also no decision on the form of compensation. It is highly unlikely that Poland will ever have a restitution programme. The 1996 law on privatization does not mention restitution at all.

Ten per cent of the value of Estonian state properties were restituted. As seen above, a strong nationalistically-minded opinion even argued that restitution should be the basic privatization method. This was not finally chosen, but the use of half of net sale revenue for the Compensation Fund is also evidence of the unique importance given to restitution in Estonia.

Any land or other physical property unlawfully expropriated under Soviet rule is potentially subject to physical restitution. Altogether, 206,275 applications for 157,959 properties were submitted in a country with 1.5

million inhabitants. Three out of four applications concerned farms or land. The process of actual restitution, already started in 1992, was slow. Applications were to be filed by 31 March 1993. By September 1995, 60 per cent of applications had been processed (Purju, 1996). Restitution and land privatization in general have been interdependent processes.

In many cases physical restitution is impossible or not wished. Then, vouchers are used. Estonia introduced two kinds of compensation vouchers. Restitution vouchers are a compensation to owners of pre-1940 property. National capital vouchers are based on the number of years employed in Estonia. Both vouchers can be used interchangeably for the privatization of housing and land, for purchase of shares of state enterprises, and for purchase of shares in the Compensation Fund. By mid 1996, vouchers with the face value of 13.4 billion EEK had been issued and this figure is expected to reach eventually 18.5 billion. About 5 billion EEK of these have been redeemed, mainly through housing privatization. Vouchers have also been used for buying minority shares in auctions for about 20 well-known enterprises. Finally, residents can use vouchers to pay for up to a half of the purchase price of shares in tender auctions.

In the Estonian case, the political will for restitution has been clear. The cut-off date was easy to choose, and the introduction of national capital vouchers overcame a potential problem of fairness. There are a number of ways of using vouchers. Still, in the market vouchers are traded with a discount of more than 80 per cent. One reason for this is the high total face value of vouchers issued. The expected total amount of 18.5 billion EEK is almost half of Estonia’s 1995 GDP (and almost equals the 1993 GDP). The value was calculated on the basis of property assessment, but given the importance of sales and strategic owners in Estonian privatization, sufficient supply of assets cannot really be expected. The slowness of land privatization is a further problem. In most cases, vouchers are simply an indirect method of free distribution of existing housing rights.

The Lithuanian voucher-based privatization programme also included an important element of restitution. Restitution only included immovable property and only applies to citizens residing in Lithuania. The authorities planned for a speedy process. The deadline for filing claims was 31 January 1992, and nearly 600,000 requests for land were received in a country of 3.6 million inhabitants. A successful claimant could receive either the old property, an equivalent plot of land, or compensation.

Many of the details of restitution remained unresolved when the programme was started. Temporary *kolkhoz* and *sovkhoz* administrators were authorized to restitute or otherwise privatize a substantial portion of agricultural assets within an initial period of some half a year. The fact that the many re-emerging private farms were tiny contributed to a left-wing political turn with repercussions throughout the society.

3.3 Management and employee buyouts

In an employee buy out (EBO), employees of a state-owned enterprise acquire the shares of the firm, or its assets to form a new company. The number of shares bought by each person can vary according to length of service, position and pay. The pricing of shares may be market-based or privileged. Management buyouts (MBO) and combined management and employee buyouts (MEBO) only differ concerning the actual buyers.

Among the countries in our sample, buyouts were most frequent in Poland. The share of buyouts is highest in Estonia. There all buyouts were part of a competitive open tender. Therefore, the Estonian case does not merit a separate discussion here. In some cases privatizations intended as being something else, usually open access voucher privatization, actually became buyouts. In Lithuania insiders used open access vouchers to acquire major stakes in their own workplaces. In Russia, insiders were given such privileges in voucher-based privatization that most enterprises became insider-dominated. These two cases are however discussed below in those sections in which original policy intentions place them.

Several arguments were produced in favour of buyouts. The new share-owners have a motivation to higher productivity, and they may have better access than outsiders to information relevant for monitoring the managers. Buyouts are easy to implement, and they may well be the only way of compensating insiders for the *de facto* property rights that have been formed in the course of socialist reforms. Without privileges, insiders may block privatization as a whole. A buyout may also lead to greater emphasis given to protecting employment than less to real wages in labour market adaptation. This may be a socially preferable outcome.

On the other hand opponents have found buyouts wanting in several respects. In developed market economies, the incentive impact of insider ownership is usually regarded sufficient even with minor (say 5-10 per cent) insider ownership share. EBOs are rare, and MBOs usually a crisis solution (Boycko *et al.* 1995). EBOs may well emphasize both wages and employment at the cost of profits and investment, especially if shares can only be sold inside the enterprise. This means an efficiency loss. And if insider-held shares are not freely circulating, the development of capital markets will suffer. From the insider point of view, putting one's capital in one's workplace increases the loss suffered in case of a bankruptcy. Therefore, decision making might be overly cautious and the pressure for state subsidies and other privileges strong. And though insiders have knowledge about the company, they may not have new knowledge and competencies to bring into the enterprise. Furthermore, many insider competencies like membership in the former ruling party may be irrelevant or worse in the new environment.

From the government point of view, sales to insiders are usually at a discount and therefore a loss of revenue. Alternatively, the government may have to offer credit for buyouts. If the credit is on market conditions, newly privatized companies are burdened with loans from the beginning. From the external investor point of view, insider ownership may be a major deterrence. Outsider investment may simply be prevented; outsiders may not want to be owners in an insider-dominated company for fear of conflict of interests; or insiders may demand excessive prices for their shares to compensate for the probability that an eventual outsider dominance endangers existing jobs (Blanchard 1997). There is also a consideration of fairness. Buyouts leave managers and employees in different jobs in totally different positions.

In practice, buyouts have been frequent in countries like Poland, Hungary, Lithuania and Russia, where insiders for various reasons had a high *de facto* ownership stake prior to privatization. Where this stake was low, like in Czechoslovakia, buyouts are not specifically mentioned in legislation. But even here insiders had some advantages (Bornstein 1996). Legislation decreed that the managers were supposed to prepare the basic privatization proposal. Competing projects could be submitted by prospective buyers. This gave the insiders a clear information advantage, and at least in the first wave of privatization 82 per cent of approved projects had originated with the managers. But only relatively few involved MBOs and in practice none involved EBOs or MEBOs. The MBOs have usually not proven financially viable.

Hungary, on the contrary, encouraged since 1992 the formation of EBOs as a way to speed up the privatization of smaller state-owned enterprises through closed tenders. By April 1995, 202 companies (with on average 200 employees) had been thus privatized (Bornstein 1996). The privileges given included, until 1995, a nominal cash down payment with exceptionally easy terms given to credit for the rest of the price. Still, the acquired debt burden is the major problem of these enterprises. It is expected that many of them will be bankrupt in due time. These privatizations were actually MEBOs, as a relatively small number of managers usually emerged with a controlling block of shares. The management initiated and led the acquisition and it had better access to cash and credit. In exchange of continued control by the managers, the non-managerial employees were given a degree of employment guarantees.

In Poland, employees accumulated important property rights especially in the 1980's, but the attitude of the first post-communist government to employee ownership was lukewarm at best. Therefore, the role of insiders became a tendentious issue in Poland. Of the two major privatization methods designed in the 1990 privatization law, somewhat peculiarly named capital and liquidation privatization, only the latter facilitated MEBOs. But is was also the prevalent one. By mid 1995, 142 enterprises had been privatized by the capital track and 1,260 by the liquidation track. Of the latter, 71 per cent involved MEBOs. But the enterprises privatized by the liquidation method were usually smallish with less than 200 employees. In total state privatization revenue in 1991-94, the capital track accounted for 63 per cent (Bornstein 1996).

In capital privatization, employee councils are abolished in the course of corporatization. In compensation, employees were offered the possibility to buy up to 20 per cent of shares at half price. More could be bought at the market price, but only in a few companies did employees acquire full or dominant blocks of shares.

Liquidation privatization can mean either conventional bankruptcy, or a more complex process where the assets of a state-owned company are leased, sold or otherwise transferred to a new private company. Thus, assets continue working, but under new legal status and ownership. MEBO usually proceeds through a lease. More than half of enterprise employees must become shareholders in the new company. They make a down payment of 20 per cent of the book value of the old company, and the lease contract is usually for 5-10 years. After that, the assets become true property of the new company. Employees acquire majority of shares, and though they tend to sell some of them, the majority is kept for at least a few years (Filatotchev *et al.* 1996). Still, managerial control of the enterprise is rarely challenged.

The financial condition and perspectives of MEBO enterprises in Poland varies notably. Usually, not only smallish but often also problematic enterprises were chosen for buyouts. Contrary to frequent expectations, many of them now seem viable, though access to finance is a widely cited problem. The partiality of property rights under leasehold, inability to pay the leasing fees and, usually self-imposed, restrictions on transferability of shares are among other critical issues.

3.4 Mass privatization

In mass privatization, a portion of state assets are transferred free to all the citizens of the country. The transfer is in practice done through vouchers to which all citizens have potentially equal access. Equal-access or mass privatization was the basic privatization method in Lithuania and the Czech Republic, and in a somewhat different form in Russia. Estonia, as noted above, has used vouchers as one of the privatization tools. In Poland, mass privatization was planned for and debated for years but it was slow to get underway.

The arguments in favour of equal-access voucher privatization are several (Lipton and Sachs 1990; Blanchard *et al.* 1991). Mass privatization is speedy and arguably fair, as all citizens are among the beneficiaries. It does not demand possibly non-existing domestic capital, and the spectre of foreign capital is also avoided. And by promoting popular capitalism it may be help the political fortunes of the reform and reformers. A distribution of vouchers gives the population the freedom of choice among competing investments, and the ensuing wide dispersal of shares helps in the development of capital markets. But on the other hand mass privatization may reduce fiscal revenue,[7] may lead to an excessively

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[7] This is not necessarily crucial. First, revenue from other privatization methods has proved much less than expected. Second, partial mass privatization might actually enhance revenue if sale prices were increased because of the greater political credibility possibly created by the probable irreversibility of fast mass privatization. For the theoretical argument see Schmidt (1996) and Schmidt and Schnitzer (1996).

dispersed ownership and thus to problems of governance, and does not infuse new capital, skills and technologies to enterprises. The free distribution of vouchers may fuel inflation, and the freedom of choice by voucher holders may be illusory due to lack of information and market infrastructures.

Mass privatization was proposed in Russian *samizdat* in 1985 and openly in Poland in 1988 (see Lewandowski and Szomburg 1989). Several other proposals followed. Lewandowski was made the minister in charge of privatization in 1991. He proposed a smallish programme of some 400 enterprises, whose majority of shares would be transferred to a limited number of investment funds to be established by the state. This was a clear contrast with the down-to-up approach of the Czechoslovak programme. Some shares would also be given free to employees, others retained by the state treasury. Each citizen could acquire for a nominal fee a tradable ownership certificate in each fund. Each fund would be run by a consortium of several Polish and foreign management and banking companies. There would be one fund controlling each of the enterprises. The funds would be responsible for restructuring the enterprises so that eventually they could be privatized by sale.

The programme seemed well-crafted, combining the final goal of sale with foreign pre-privatization expertise and the satisfaction of employees as stakeholders. Each citizen would get a similar portfolio in the funds, so no choice in face of uncertainty would be forced upon them. But the programme was also hugely complex; it left majority ownership with state-created bodies, it would generate no immediate fiscal revenue though that was badly needed both for the budget and for servicing foreign debt, and it left no immediate choice with the citizens. In spite of such doubts, the Lewandowski plan was strongly endorsed by the international financial institutions. Notwithstanding some amendments (Bornstein 1996), it got stuck in the political process, was only accepted by the parliament in April 1993, then by the new left-of-centre prime minister in December 1994, and was finally defeated in a referendum in early 1996. Only a limited version with 512 enterprises and 15 national investment funds is being implemented, though citizens' interest in receiving vouchers was much higher than expected. Vouchers have already been exchanged for national investment fund shares, which became tradable in June 1997 (Kolodko and Nuti 1997).

The Czechoslovak programme differed from the Polish case in four important respects. First, it was not geared at enterprise restructuring by state-established funds, as the Lewandowski plan. It aimed at a wide distribution of shares among the population. Second, it did not distribute among the population a predetermined portfolio of fund shares, but vouchers with which the population could exercise freedom of choice. Third, though investment funds were planned for, they were not to be state-established but should arise from the markets. Fourth, contrary to the Polish case, the Czech programme was implemented fast and in a large scale.

The Czech mass privatization was an impressive administrative feat. The privatization law was passed, enterprises to be affected were determined, privatization projects were negotiated, the books of vouchers were distributed among the population and the first wave of computer-based centralized voucher auctions were held in 1991-92. Because of the split of the country, the second wave was delayed until 1994 but still the process was a speedy one. Crucially, it also produced an unintended but welcome institutional development in the form of investment funds that collected about two-thirds of the voucher points and became not only important financial intermediaries but also central for corporate governance. The government had expected dispersed popular capitalism; in fact almost all of the largest investment funds are dominated by Czech banks, themselves often with large remaining government stakes. In mid 1994 there were about six million individual shareholders. By the end of 1995, an estimated one third of them had already sold their shares in most cases to funds (OECD 1996: 67).

In March 1991 in Lithuania, a law was introduced calling for voucher privatization. In addition to the usual arguments, vouchers were advocated as a way of keeping Russian money out - even the currency reform had not yet taken place (Samonis 1995: 13). More than in the Czech republic, about two-thirds of state-owned property was to be subject to mass privatization. In addition, vouchers were also used for housing and land privatization. To minimize any inflationary impact, vouchers were originally only legally transferable to relatives. This restriction was relaxed in 1993. Vouchers were distributed to all citizens, in relation to age so that elderly people got five times more than the youngest ones. Vouchers were used in auctions in a fixed combination with cash.

Unlike in the Czech republic, Lithuanian voucher privatization was decentralized into pre-announced auctions, share subscriptions and, somewhat later, business plan-based tenders. The regulations directing privatization were also amended quite frequently. In particular, employee privileges were enhanced in 1993, now giving them the right to buy 50 per cent of shares instead of the earlier 30 per cent. Local and ministerial decisions were often crucial, and this has lead to frequent allegations of fraud, corruption and insider trading. There was no unified market for vouchers, but their price varied across regions and over time. Several hundreds (the actual figure is unknown) of investment funds, many of them unlicensed, sprang up. Probably most Lithuanians placed their vouchers in the funds. Already by the end of 1992 half of all enterprises were in private hands.

The speed of Lithuanian privatization had a price. Even the relevant statistics are highly suspect, and enterprises were privatized together with their debt, arrears and social assets. There was no prior restructuring and not even a proper asset valuation. Because of the extent of irregularities, privatization even had to be stopped for a while in 1992-93. The investment funds are rather less than perfectly regulated, and often form informal groupings with larger stakes than the 30 per cent of an privatized enterprise's authorized capital legally possible. Recent legislation demands that they be transformed into open-end mutual funds. Some will do so, most will transfer their assets to other institutions. They have served their purpose by transforming an equal-access voucher privatization into a dominance of insiders and often shady business groupings.

3.5 The peculiar Russian case

In Russia, a total of 126,793 objects were privatized by the end of 1996, among them about 18,000 in mass privatization. About 30,500 firms remain as federal assets, more in subnational ownership.[8] In World Bank classification, Russian mass privatization is regarded as an MEBO. This is justified in that enterprise insiders did have the key role. But as the price paid for shares was nominal, Russia's voucher privatization actually amounts to a preferential give-away. On average, the general directors

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8 *Izvestia*, 9 April 1997.

surveyed by Blasi and others (Blasi *et al.* 1996: 40) in 1994 and 1995 said that they had paid 40 times less than the enterprises were worth.[9]

This was probably not the intention. Early Russian discussion emphasized the need for a strategy combining general sales with some stakeholder preferences and general public privileges (Bornstein, 1994; Lainela and Sutela, 1993). Even the privatization programme still set the priority on sales, but two unforeseen events intervened. First, a political compromise gave the enterprises the possibility of choosing between three alternative privatization paths. Most enterprises chose the option giving workers and managers the right to buy 51 per cent of voting shares at a price set at 1.7 times the 1 July 1992 book value. This was paid partly in money, mostly in vouchers. Second, Russian stabilization failed, and the historically based share price that had always been very low became negligible.

The Russian privatizers would have preferred (see Chubais and Vishnevskaya 1992)[10] enterprises to choose another option, one that would have given insiders a quarter of non-voting shares free, together with a possibility to buy up to 15 per cent of voting shares with a discount. The dangers of insider domination were understood well enough. But after the possibility of insider privatization had been allowed, it almost inevitably became the dominant one. From the employee point of view, share ownership was often understood as an implicit employment guarantee, and anyway the threshold of investing in another company was high. For managers, owning one’s company meant the legalization of those property rights that has emerged as central management was first weakened and then mostly abolished. In several cases, company managers tried and also succeeded in preventing outsiders from acquiring shares.

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9 Such figures are probably based on a comparison with book values. According to Popov (1996), prices paid have been one or two per cent of book values. Cheasty and Davis (1996) similarly estimate that in the former Soviet Union as a whole government privatization revenue has so far been 3.5 per cent of the book value of assets. But naturally book values for companies that have never worked in a market environment are arbitrary and probably, given what we have seen of the competitiveness of former Soviet plants, on the high side. For many firms, any positive book value is too high.

10 Two years later, the same authors (Chubais and Vishnevskaya 1994: 99) are no longer explicit on this but do emphasize that voucher privatization 'will not solve several key problems, namely, how to provide an “efficient” owner (at least at the initial stage), effective structural reforms, and capital inflow'.

After voucher privatization had been completed, a second phase of Russian privatization was implemented after much delay in late 1995. The plan was to sell remaining state stock through auctions and investment tenders. In practice privatization had become politically controversial and it nearly stopped. Nine out of ten privatized enterprises surveyed in 1996 said that they had never had an investment tender. Three out of four had had no cash auctions (Blasi *et al.* 1996: 53, 70). Government revenue from privatization was also much less than expected. In 1996, federal revenue was planned to amount to 0.54 per cent of GDP (or 12,387 billion RUR), but only 1,751 billion was received.[11] For 1997, revenues of only 0.15 per cent of GDP (4,179 billion RUR) were first planned, but as the general revenue basis of the budget collapsed, the goal was step-wise raised to about 10,000 billion RUR.

Though around 3,500 firms were privatized in 1996[12], the second phase of Russian privatization was a clear failure, and political turmoil around it continued. One reason for this was also the fact that the major part of actual privatization in 1995 consisted of a 'loans-for-shares' scheme. The state auctioned among banks the right to acquire major blocks of shares in some of the best known and potentially wealthy enterprises. The scheme was planned for 29 companies but in the end only concerned twelve. The highest accepted bid gave the winner custody over shares in exchange of a loan given to the treasury. In principle, the loan would be prepaid and the shares then sold, with the state and the custodian sharing any profit. In practice, it was expected from the very beginning that the state will be unable to pay the loan back, and the custodian becomes the owner of the shares, which can then be sold. According to the original loans-for-shares agreements, banks were to start auctioning the shares held in custody in September 1996. Actually, this only started in a small scale in early 1997, again amidst controversy.

In principle the loans-for-shares scheme might have provided a counterweight to insider ownership, but it is easy to see why the scheme provoked so much controversy in practice. The right to participate in the scheme was often auctioned at a very low price, and the highest bid was sometimes not accepted. Typically, the shares ended with a bank with close ties to the company involved. And in the few cases when the shares

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[11] *Segodnya,* 18 January 1997.

[12] *Izvestia*, 9 April 1997.

have already been sold, the new owner again tends to be somebody with close ties to the company - and to the bank selling the shares.

Like in Poland, the current Russian emphasis is on cash sale of major government blocks of shares, especially in a handful of energy and infrastructure companies. Also, like in Poland, the other emphasis is on improved governance of remaining state assets.

IV OUTCOMES OF PRIVATIZATION

4.1 Could privatization be planned?

Privatization is a policy project which really could not be planned. Even assuming that the government was able to present a privatization plan to the parliament, the parliament might not pass it - as happened to Polish mass privatization - or totally new privatization methods might be added to the ones proposed. This was the case with Russian insider privatization and Czech restitution. In Estonia, a country which is regarded a model of policy consistency, successive governments emphasized either restitution and vouchers or sales. But when the latter path was finally chosen, it was pursued with notable determination.

In other cases - Hungarian restitution and Russian multiplicity of privatization options are clear examples - internal government divisions had a major impact upon the choice of methods.

Obviously, variation in state capability mattered. In Lithuania, privatization seems to have been such a spontaneous and decentralized process that it even had to be stopped for a period of time. On the other hand the Czech Republic and, given the history, perhaps somewhat surprisingly Estonia were generally well able to manage privatization. But even in these countries the distribution of property rights produced by privatization diverged from the one originally conceived. In that sense not even these countries were capable or willing to exercise close regulation.

4.2 Who owns the enterprises?

Information on the distribution of property seems to be worst in the Baltic states. No global percentages concerning, for instance, the shares of insiders and outsiders, of foreign and domestic owners, of financial institutions and others, and of the existence of block owners are available either in Estonia or in Lithuania. The best information comes from surveys reported by Jones (1997). In Lithuania, it is generally believed that equal-access voucher privatization actually lead to prevalent insider dominance, which is now complemented by an emergence of perhaps six or eight relatively strong financial groupings. In a sample surveyed in mid 1994, insider ownership averaged between 34 and 37 per cent of available shares. Almost a quarter of firms were majority insider-owned and a third insider-dominated.

In Estonia the share of insider ownership is surprisingly high, given the privatization method chosen (Jones 1997). In early 1995, non-managerial employees still owned majority stock in 67 out of 403 enterprises, of which there is information. Managers were majority owners in 88 companies. The role of employees has been decreasing, that of managers increasing.

In the Czech case, voucher privatization lead to a bank-dominated financial system. The (about 400) investment funds gathered 72 per cent of all voucher points in the first wave of privatization. The funds thus became crucial outside owners of enterprises. Among the ten leading funds after the first wave of privatization, seven were bank-affiliated, two private and one affiliated with an (state-owned) insurance company (Grosfeld, 1996). The four largest bank-affiliated funds attracted more than 40 per cent of all voucher points. In the second wave, concentration was less, but the general picture did not change. Regulations limiting banks' involvement in non-financial companies were issued, but seemingly also violated systematically. Cross-ownership of banks also evolved. And in the end of the ownership chain, the state still has controlling interests in most of the large Czech banks. The state owns about a third of banks; the banks own about half of industry. Therefore, a Czech analyst concludes 'if we want to know who controls a typical Czech privatized enterprise, we mostly find a complicated chain of capital shares in the end thereof being NPF' (the National Property Fund, i.e. the state; see Mertlik 1995: 328). Opinions differ on whether the state uses ownership relations for intervention; the authorities say 'no', many observers 'yes' (OECD 1996: 69).

It is not evident that such 'state capitalism' will remain in the Czech Republic. On one hand, bank affiliated funds may have acquired stakes in large numbers of enterprises to maintain old and develop new bank-enterprise client relations (Coffee 1996). Unable of efficient control of numerous companies, they are under pressure from the more active and better focussed private funds and foreign investors. Selling shares may be the best way of earning revenue. This is also true of the small investors in funds. It is believed that 'a period of dramatic secondary restructuralization of property rights' (Mertlik 1995: 330) arrived in the Czech Republic in 1995. The process has slowed down by the unwillingness to allow foreign stakes in Czech banks, but recently that attitude seems to have given way. The transparency of the 'secondary restructuralization' is hindered by the fact that most trading is over-the-counter. The stock exchange is quite deficiently regulated. And it has not yet been possible to determine the future role of the funds. Severing their ties with the banks might be a necessary step (Coffee 1996).

But meanwhile an increasing number of critics are laying the blame for the Czech Republic's recently modest economic performance - slower growth, wage pressure, trade and even budget deficit together with financial scandals, a weak banking sector and a feeling of lost political orientation - at the feet of mass privatization: 'Nearly all of these woes, the critics say, have a common root. The country's mass privatization campaign ... had all the makings of a radical break. And it was - on the surface. But a quick change of owners rarely brought cash, initiative, or a fresh dose of courage, all of which are badly needed now'[13]

If the Czech mass privatization may have originally been intended to produce an Anglo-American type stock exchange-dominated financial system with dispersed equity ownership, but failed to deliver that, the Polish mass privatization programme clearly aimed at creating strong strategic owners in the form of the state-established funds (Grosfeld, 1996). In this sense, it aimed at a Continental financial system. But mass privatization was only recently started, and in the meantime Polish banks remain generally reluctant to take equity stakes in non-financial enterprises.

Given the crucial role of MEBO's in Poland, it is no surprise that, according to Earle and Estrin (cited in Estrin 1996), in 75 per cent of privatizations employees became the dominant owners holding on average a slim majority of 50.8 per cent of shares.

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[13] *Central European Economic Review*, May 1997: 12.

In Hungary, the development of interwoven (Chavance and Magnin 1995) or recombinant (Stark 1996) ownership started with the spontaneous privatization of the late 1980s. Many large state-owned companies have been transformed into a group of new companies, established on the basis of divisions or departments of the old company. The parent company usually maintains control over the satellites, but part of shares is divested to foreign and domestic private investors, banks and other financial institutions as well as to other companies, usually suppliers or customers. Corporatization made debt for equity swaps possible, economic recession made them almost inevitable. As a consequence, a complex and interwoven net of property relations emerged, making the distinction between the public and private sectors highly relative.

In Russia, insiders dominate most of the industry. Overall information is not available, and different surveys produce somewhat different distributions of ownership. It is reported that among enterprises to be privatized 53 or even 73 per cent chose - from among three alternative privatization methods[14] - the so-called ‘Option 2’ leading to insider dominance. According to the Blasi studies, nine out of ten privatized companies had majority ownership by employees in early 1994. Later a tendency towards the dilution of insider dominance developed, not least of all because of the high mobility of labour in Russia. But it seems that this tendency stopped in 1995, and the share of insider-dominated firms seems actually to have risen by 1996 (see Table 4). Some part of the earlier dilution is also illusory, as seemingly outside investors may often be little more than middlemen acting for insiders, usually managers.

There is little doubt that managers are usually the active Russian owners. Managers have also strengthened their position by purchasing shares from the workers or at cash auctions or investment tenders, by stock buybacks and directed stock issues. In 1996, they owned, according to the Blasi studies, on average 18 per cent of Russian stock (Table 5); employees owned 40 per cent - actually marginally more than the 39 per cent in 1995. In practice, the position of managers is much stronger than their ownership share would indicate. A survey of 66 enterprises in and around Moscow and St Petersburg found that employees were dominant owners in 58 per cent and had dominant control in 50 per cent of the companies. Managers,

[14] For a description of the different options, see Lainela and Sutela (1994).

in contrast, were dominant owners in only 8 per cent of the companies but controlled 41 per cent of them. Outsiders, including the state that was a completely ineffectual owner, controlled only 9 per cent of the companies. Even this small survey contained cases where also non-state outside owners were unable to control companies which they effectively owned.[15]

TABLE 4. MAJORITY OWNERS OF PRIVATE SECTOR CORPORATIONS IN RUSSIA, 1995 AND 1996 (PER CENT)

Majority owners	1995	1996
Employees	59.0	64.7
rank and file	26.7	30.5
managers	2.3	4.2
top managers	0.4	0.4
general directors	0.4	0.8
no majority insider	29.4	28.8
Non-state outsiders	17.3	19.8
State	3.1	2.6
None	20.3	12.8

Source: Blasi *et al.* 1996, Table 5.

Employees may see share ownership primarily as an implicit employment guarantee. Thus, as long as they remain with their job, they might support oft reported management efforts to prevent employees from selling shares to outsiders. If they leave the job, management may be the natural buyer of the shares. Trust arrangements between workers and managers are frequent (Lieberman and Rajuha 1994). This seriously limits the possibilities of such outside investors as investment funds that otherwise might be more eager than insiders to foster the kind of restructuring that Russian firms clearly need (Frydman, Pistor and Rapaczynski, 1996). Majority outsider ownership does make a difference in terms of restructuring and productivity. But such cases are quite rare in Russia, and examples of complete turning round of companies are more rare still.

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[15] Klepach *et al.*, cited in *Russian Economic Trends* 1996: 118-120.

TABLE 5. OWNERSHIP OF RUSSIAN ENTERPRISES, 1994-96, PER CENT OF SHARES

	1994	1995	1996
Insiders	65	55	58.0
top managers	7	8	10.0
other managers	18	8	8.0
other employees	-	39	40.0
Russian outsiders	21	32	32.0
citizens	-	9	6.0
unrelated commercial firms	-	8	11.0
suppliers	-	3	2.0
customers	-	2	1.0
other firms	-	2	1.3
investment funds	-	6	5.0
holding companies	-	1	2.6
banks	-	1	1.6
pension funds	-	-	0.02
insurance companies	-	-	-
Foreign entities	-	1	1.6
State	13	13	9.0

Source: Blasi *et al.* 1996, Table 4, slightly amended.

Overall, by the summer of 1996 outsiders owned about one third of the shares of Russian industry (Blasi *et al.* 1997). They own shares in nine out of ten Russian firms. But as table 4 tells, they are majority owners in only about 20 per cent of companies. And only 2 per cent of enterprises has a single outside majority owner. Clearly, outsiders have not seriously challenged management in most Russian enterprises. An interesting question is whether they will do so in the future - and if so, who these outsiders will be.

At the moment, the most common outsider owner of Russian firms are commercial firms, followed by Russian individuals and investment funds. Only rarely are foreign companies among the owners. 'No one really has a clear idea' about who the commercial firms are, Blasi *et al.* (1997: 55) conclude. Voucher investment funds have proved a disappointment, especially if compared with the Czech case. In Russia they only control 5 per cent of companies, and have no shares in half of them. Another possible surprise in Table 5 is the meagre role of banks as company owners. But one has to remember that the joint capital of the Russian banking system is less than, for instance, that of the Finnish banking system. The banks have scarce resources and have been squeezed by the recent lower inflation, stable exchange rates and lower even if still high interest rates. The bank-enterprise cross ownership is concentrated in a relatively small number of financial-industrial groups.

Altogether, Russian mass privatization has produced a highly skewed distribution of ownership. Russia may have forty-five million share owners. This is a huge number, especially given the speed of privatization. But still the insiders of privatized enterprises, who own 59 per cent of the stock, are only a fraction of the population. Many more have no share ownership, and a large part of the population has only little stock, either directly or through investment funds. Ownership of the important 'commercial firms' is surely very narrow. These facts have had well-known political repercussions.

Interestingly, the ownership structure of the largest Russian enterprises differs sharply from the general picture. Among the largest 100 companies, private Russian investors on average own 39.1 per cent of shares, foreign investors 15.7 per cent. The state on the average retains a 20 per cent share holding while insiders have about 22 per cent.[16]

4.3 Privatization and economic growth

Arguably welfare is higher in a market economy than in a planned economy with similar income level, especially when the political and civil society dimensions of wellbeing are emphasized. The main economic argument favouring the transition must however be that the market economy is, other things being equal, able to create and sustain higher growth rates than a planned economy. Attempting a final judgement would surely be premature. But some speculations are well-warranted. The discussion here is limited in two dimensions. All issues of measuring GDP and welfare will be bypassed, and this section concentrates on the macroeconomic connection between privatization and growth.

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[16] *The Financial Times,* 25 March 1997, citing research by Joseph Blasi.

Has privatization enhanced economic growth in the transition countries? Logically, the question divides into two sub-problems. What is the impact of expected privatization on state-owned firms? How do enterprises produce after privatization?

In an early model Aghion, Blanchard and Burgess (1994) argued that the prospect of privatization is actually an enemy of enterprise restructuring. As incumbent managers will be fired after privatization, they stand to lose from restructuring and will not restructure. Therefore, the economy suffers as privatization may be postponed. Clearly, speedy privatization is called for. Even earlier, other analysts had raised the spectre of asset looting if privatization is not immediate.

The Aghion *et al.* result is however dependent on the assumption of all incumbent managers being fired after privatization. In an economy with scarce managerial skills that is not a plausible assumption. Actually, as Kotrba (1996) shows, pre-privatization restructuring is a useful signalling device for the managerial labour market. In a competitive environment the new owners have the incentive to keep restructuring managers. On the other hand it is possible that managers of at least smaller companies plan a MBO. There is some evidence that in such a case they may well run the value of the company down (OECD 1995b: 115).

Such theorizing is corroborated by a number of studies concerning adjustment of state-owned firms, especially in the Central European economies. Josef Brada (1996: 81) concludes: 'Managers of firms facing a credible prospect privatization often worked hard to make their firm attractive to future owners'. In particular, there has been no wholesale decapitalization of firms, and contrary to earlier beliefs (Kornai 1990), the hardening of state enterprise budget constraints has been possible.

Recently, a number of studies have focused both on the connection between reform policies and output change in recent past (Fischer, Sahay and Vegh 1996; Sachs 1996; Åslund, Boone and Johnson 1996; de Melo *et al.* 1996; World Bank 1996) and on the growth prospects of transition economies (IMF 1996; Sachs and Warner 1996; Baldwin, Francois and Portes 1997). Typically, these studies use an index of the extent of market reform to explain the variability of economic performance. There is strong evidence that advanced reformers have suffered less output loss, have lower inflation and have embarked upon growth faster than slow or hesitant reformers.

In the most important of the backward looking studies, de Melo, Denizer and Gelb (1996) have devised a composite liberalization index as a weighted average of liberalization in internal markets, external markets and private sector entry. This index has for the 26 countries studied strong positive correlations with average annual GDP growth in 1989-94 (0.59) and in 1993-94 (0.73) as well as an even stronger correlation with average annual inflation rates for the same periods (-0.74 and -0.81).

The private sector entry component of the cumulative index (with a weight of 0.4) actually consists of two things, small and large scale privatization and banking reform. Therefore, it is interesting that the authors also provide the correlation coefficients between all the three components on one hand and GDP and inflation performance on the other. All the coefficients are very similar and thus close to the general ones cited above.

Is this evidence that the extent of privatization has driven output and inflation performance in the 26 economies studied? Such a conclusion would be risky for several reasons. First, there are well-known and acknowledged problems with the data. This does not only concern output and inflation data, but also and perhaps especially the indices for progress in reform used. Giving points to, say, privatization in different countries is a heroic attempt to measure something that does not let itself be easily measured, especially when the inevitable differences between reform legislation and its actual implementation, between formal and informal institutions is born in mind (Murrell 1996). It is actually quite difficult to gauge how large are private and state sectors in different countries, as the dividing line is often quite murky, as seen above (also see Brada 1996). Second, identical points may well refer to quite different settings. Thus, de Melo, Denizer and Gelb (1996) use the European Bank of Reconstruction and Development transition indicators (see EBRD 1996) as the starting point of their assessments. EBRD currently gives the same number of points to large scale privatization in the Czech Republic, Estonia and Hungary. These countries may be similarly progressed in privatization, but their actual property arrangements are quite different. Third, as the authors emphasize, it is difficult to distinguish between the contribution of new private sector development and privatization to economic growth. They measure privatization, while *ab novo* enterprises may be more important.

Fourth, the complementarities of reform policies - so amply emphasized by de Melo, Denizer and Gelb (1996) - imply that the components of their liberalization index are highly multi-collinear. Therefore, as pointed out by Murrell (1996), trying to separate the impacts of different reform components may not be reasonable.

Existing macroeconomic discussions on the growth prospects of transition economies not surprisingly tend to emphasize the savings-investment connection. Therefore, the stress is on prudent fiscal policies, higher private saving ratios, foreign direct investment and the efficiency of financial intermediation. The need to finalize privatization may be mentioned, even if without theoretical or empirical trappings (Sachs and Warner 1996), but issues like pension reform get a much fuller treatment (also see EBRD 1996). Again, the complementarities of credible and consistent economic policies are often emphasized in such studies, but without a micro-to-macro mapping from privatization through corporate governance to economic performance. A related issue - the proper role of state in establishing property rights - in furthering corporate governance and in general in helping institutions to develop is however discussed by the World Bank (1996) and also touched upon by the IMF (1996). The necessity of the legal framework for growth is well known (Hay, Schleifer and Murphy 1996) as is the fact that corruption can seriously impair growth (Murphy, Shleifer and Vishny 1993; Mauro 1995). The fact that institutional development is poorly understood and the properties of alternative arrangements remain murky at best, however seriously limits the possibilities of social engineering in the future as well.

Early comparative studies of corporate governance in transition economies generally concluded that systematic differences in the behaviour of privatized and state-owned enterprises have been somewhat slow to emerge, if they can be detected at all (Brada, 1996; Murrell, 1996). A later comprehensive study by the World Bank concluded that there is an evident difference in the performance - measured by productivity and wage constraint - of privatized and state-owned firms (Anderson *et al.* 1997): 'rapid and comprehensive privatization leading to concentrated ownership encourages restructuring'. Equally interestingly, they found little if any variation across the Central European transition countries. The privatization paths chosen, as long as they produced concentrated ownership, seemingly did not matter. This result is somewhat contradicted by another study (Carlin and Landesmann, 1997), where performance was measured by the quality of exports to Western Europe. Here, Central Europe emerges as much better than, e.g., Russia, where privatization has been accompanied by increasingly resource-based exports. Polish *ab novo* enterprises export goods of low quality characteristics. Hungarian sales-based privatization has created a quality export-oriented sector of the economy, which however has only little impact on the rest of the economy. Evidence on the Czech case is not conclusive, but tends to support the view that privatization there has lead to notable corporate governance problems.

Analysts are generally unanimous that *ab novo* private activities do make a difference and are the major engine of economic growth in transition economies (see, in particular, Johnson and Loveman 1995). But the extent of private sector development differs across countries. While entrepreneurship powers Poland's fast growth, it is less than clear that in 1996 the second economy grew at all in Russia (Pavlenko 1996). Whence the difference?

Frye and Shleifer (1996) provide one part of the explanation. Their comparative survey leads to the conclusion that the regulatory, and to some extent the legal, environment is a good deal friendlier to business in Warsaw than in Moscow. Others, like Murrell (1996) and Hanson (1997), look at the deep social and historical differences in institutions, policy processes and social capital. Each transition economy is proving its uniqueness. Not only are privatization outcomes different, but their impact upon economic performance is channelled by mechanisms that are to an extent socially unique. Russia is a case in point.

V A CASE STUDY: THE FUTURE OF OWNERSHIP IN RUSSIA[17]

Russian corporate governance is, thus, outside the largest companies based on an alliance between employees and managers. Employees protest openly only when they feel both being pawns in an alien game and, what is more, also feel that the managers are playing the game in a clearly incompetent way. Employees may actually even have an interest in

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17 This section is partially based on Sutela (1995).

managerial control (Frydman, Pistor and Rapaczynski 1995). Having clear authority within the company tends to lessen the possibilities of ownership dilution by actually making it more difficult to sell shares to outsiders. And if outside ownership increases the probability of downsizing, employees charge a higher price when selling shares to outsiders than to insiders (Blanchard and Aghion 1995). Furthermore, Russian employees and managers are often pictured as having an implicit contract on employment and basic social security. Having clear managerial control tends to prevent the existence of a large number of free riders, who by selling their shares to outsiders threaten the maintenance of traditional enterprise stability. Most Russian firms have been survival oriented, and the closing of ranks around managers is a way of trying to survive.

Over a longer period of time this alliance may well prove too fragile to bear the burden of restructuring. As productivity has collapsed, maintaining very low involuntary unemployment levels seems only possible as long as real wages remain very low or soft finance is available from the government. Restructuring in the first phase of economic upturn may therefore break the current arrangement. In another scenario managers want to keep enterprises economically viable and sustainable economic stabilization - including hardened budget constraints - finally succeeds. In that optimistic case, managers must sooner or later face the corporate control challenges raised by share issues to attract outside equity capital. The immediate post-privatization ownership arrangements may therefore well prove to be temporary. In a few cases already, company crises have given outside investors the chance to take control.

Russia is not a case of employee ownership. Managers, not employees, are the active owners, and they are usually able to count on the support of the latter in important questions like defence against outside raiders. As has been often pointed out, there is good reason to believe that insider ownership, in addition to being highly suspect from an equity point of view, may lead to less structural change, investment and efficiency and more rent-seeking, protectionism and paternalism than a more normal outsider-based capitalist distribution of property titles might do (Sutela 1994). In short, insider-controlled enterprises might not be profit maximizers. There is evidence that current Russian enterprises do not maximize profits (Kleiner 1994). A large scale survey of privatized Russian enterprises even finds a negative correlation between the relative importance of insider ownership and enterprise efficiency (Braverman, Klochkov and Lyukmanov 1994). The real issue naturally concerns the impact of insider privatization upon the long term structure and performance of the economy.

In literature related to developed market economies, several arguments have been developed concerning management ownership. The classical argument for the benefits of managerial ownership concerns incentives. If managers have to bear the financial consequences of their decisions, the probability of them acting in line with the interests of other shareholders increases. There might be less consumption of perquisites and more unobservable managerial effort. On the other hand, too high managerial ownership share might well lead to too much risk taking. It might also lead to highly inefficient managerial labour markets and it would in any case not be compatible with the need to raise outside capital. In the well-qualified opinion of Shleifer and Vasiliev (1994), the optimum share of managerial ownership is somewhere in the range of 5 to 10 per cent.

Russian reformers and their advisors are naturally aware of the problem. As an early report (Institut Ekonomicheskogo Analiza 1994) puts it:

> '...the main achievement of past voucher privatization was indeed the possibility of implementing it in the concrete Russian circumstances of 1992-1994, and, in particular, its organizing in a manner which gave incentives to any social group of some importance to participate, or at the very least, to secure their neutrality. The original distribution of property did take place. And therefore what happened was not so much economically rational and efficient, as politically possible and socially acceptable. The efficient redistribution of property, facilitation of investment, structural change of production, and change in the characteristics of management all remain the primary tasks for the next, monetary phase of privatization. It may thus be said that voucher privatization was just the preliminary phase, an invitation to a real redistribution of property'.

The problem to be asked in this section, then, is whether the Russian insider privatization of past years should be seen as having already led to a relatively permanent arrangement, or whether the Coase Theorem might be relevant for Russia. The particular theorem by Ronald Coase invoked here says that if efficient markets in property titles exist and if property titles are assigned clearly, the actual original distribution of titles is of no importance, as an efficient distribution will emerge over time. Put more prosaically, we are addressing two related but separate questions: (1) how much path dependence is involved in the distribution of Russian property titles, and; (2) how efficient might Russian secondary markets for property titles become in the foreseeable future? The discussion only concerns the Russian case, and no explicit conclusions are drawn concerning the eventual possibilities to apply the analysis in other societies.

Russia now stands in front of several issues of ownership and control. One way or another, they have to be solved. Pointing out that these choices are highly relevant, and focusing on some of the issues involved will hopefully shed light on some of the truly historical dimensions involved in Russian post-privatization developments.

Joseph Stiglitz (1994) points out that what is commonly called the Coase Theorem is actually a conjecture. It was never stated in a precise form. Stiglitz also argues that though the absence of clear property rights often gives rise to problems, well-defined property rights do not necessarily lead to efficiency in the presence of public goods, transaction costs or asymmetric information. Thus, the Coase Theorem is in this view not strictly true in most environments. Also, according to Stiglitz, the absence of well-defined private property rights need not always give rise to problems. He also argues that privatization does not always dominate public control.

Central and controversial as these concerns are in the science of economics, discussing them is not the purpose of this paper. Ours is here a much more limited problem. Given that privatization has been diagnosed as a primary part of Russian and other transformations, given that Russia has implemented insider privatization, should one expect such property rights to remain relatively permanent or not?

First we turn to the issue of path dependence. In the case of Russian property arrangements, path dependence might be crucial for at least two main reasons. First, Russians may have chosen insider privatization over the other options because of their cultural values, which emphasize the importance of the collective. The Russian collective, it is important to understand, includes the manager as the leader. It is therefore only natural that while the majority of Russian enterprises have changed general director since 1992, in four of five cases the new chief is another insider (Blasi *et al.* 1996). Such emphases would be a natural extension of Alexander Zinoviev's theories of *homo sovieticus*, and the approach has been proposed in less extreme forms by Russian sociologists (Magun 1994). To the degree that one believes in the relative permanence of such cultural specifics, one might argue that insider ownership tends to remain dominant.

Second, property is not only about economic efficiency, it is also about power, prestige and privilege. During the last years of the USSR, as the position of central institutions deteriorated, plant- and regional-level managers increasingly found themselves the subjects of remaining economic co-ordination and decision-making power. Eager to explode existing institutions and seeing central ministries and other authorities as the main danger to the irreversibility of ongoing transformation, the Russian reformers concentrated upon undermining the power of Moscow bureaucracies. True enough, voucher privatization Option 2, the high road to insider control, was not a part of their original intentions, but accepting it was a price that they were ready to pay. And, at least if Blasi's samples are representative, it seems that other mass privatization methods have in practice implied even more insider ownership than the more commonly adopted Option 2. Surely it should have been possible to foresee that if insider privatization is allowed, it will become the prevailing route, as it gave the plant- and regional-level managers a chance to legitimize their already existing *de facto* ownership position. Having *de facto* power is nice; having also *de jure* power is even better.

It is in this sense that, to use the expression of Leonid Radzikhovskii, the Russian political scientist, Soviet nomenklatura exchanged Das Kapital for capital (Radzikhovskii 1995). Others have written about Kremlin Capitalism (Blasi 1996) and Capitalism With A Comrade's Face (Frydman, Murphy and Rapaczynski 1996). One of the problems with this solution is - as will be argued below - that from the investment point of view such exchange created capitalism without capital, i.e. investable funds.

There is a third argument for path dependence as well. As Chubais and Vishnevskaya (1992: 6-7) put it, insider-dominated firms may not be attractive objects for outside investors:

> 'Of course the subsequent sales and purchases of free-of-charge shares would eventually bring a change of owners. However, this process would take a long time, since far-sighted national or foreign investors tend not to invest in worker-managed enterprises.'

The argument is in terms of worker dominance. There seems to be no reason why it might not be true of insider dominance in general. There is no reason why the inevitability of insider privatization should have come as a surprise to Russian privatizers. And at least ex post, Russian privatizers tell that it did not come as a surprise. It is told by Shleifer and Vasiliev (1994) that what we have is a case of conscious choice:

> '... if the Russian privatization program was to go ahead, the political and economic power of managers had to be recognized .... the goal of reforms was to get rid not of the managers, but of the ministries ... In fact, co-optation of managers through high equity ownership was the explicit agenda of the privatizers dictated by political necessity'.

Naturally, the economic arguments in favour of (limited) managerial ownership were also known. But still it was obvious to Russian privatizers immediately after mass privatization that the goal of co-optation overshot in the sense that now 'the Russian managers are far too entrenched' (Shleifer and Vasiliev 1994: 15-16). Such corporate governance mechanisms as board of directors oversight, proxy fights, take-overs and bank lending are little developed. The great question is whether insiders are willing to see their position weakened. The secondary question is whether that should take place primarily through securities markets or the banking system. Finally, one should ask what is probable to actually happen.

Debates on the relative power of ministries and managers in the late Soviet economy will remain with us for a long time to come. Still, it should be beyond debate that if, indeed, insider privatization has been a matter of power, it would be rash to expect a profound redistribution of property rights just for the sake of money. For Shleifer and Vasiliev, the most important argument for a long term decline in insider control is the need to raise outside equity capital for investment. And indeed, in a sense, Russian privatization created capitalism without capital. Enterprise insiders in many cases simply do not have the money so badly needed for Russian restructuring. Some of the investment funds are owned by the population at large. A bigger share is concentrated within the financial system.

So far enterprise survival strategies have not concentrated upon investment. Lobbying for subsidized finance, tax and foreign trade privileges and partial product mix shifts have been more profitable. According to press reports, managers have often also concentrated upon dubious ways of increasing their stakes in companies. The methods used are several. Some of them will be described shortly.

From an efficiency point of view, this is not sustainable. The Russian economy should be restructured and that is, among other things, a question of investment. But perhaps managerial owners really prefer poor but 'own' companies to wealthy but 'alien' ones? The possibility is evident, perhaps not least of all because of Russian traditions concerning the value of *nashi* (ours). Blasi *et al.* (1996: 174) characterize the attitude of Russian general directors as 'suicidal' and as making no business sense. When asked, both in 1994 and in 1995, three out of four general directors said that they and their employees would oppose selling a majority of the shares of their enterprises to an investor who would bring the entire amount of capital needed to modernize and restructure the firm. It is quite as evident that whether the need for outside equity capital for investment purposes becomes great or not also depends on government action, especially concerning opening up of the economy. Explicit subsidies are already of lesser importance, and the resources available for such purposes are meagre.

To round up this part of the discussion, we come back to the issue of the inevitability of insider ownership. It was argued above that insider control was indeed inevitable. This is not only an *ex post* generalization: 'the newly proposed variant of mass privatization will tend to make enterprise insiders in general and managers in particular the active owners of industry' (Sutela 1993: 20 [written in September 1992]). It was also argued that, quite clearly, insider dominance was a price that Russian reformers were willing to accept. But different voices were heard in the early 1990s as well. First, a reference should be made to the views of the best-known Russian proponent of the idea of late socialism as an administrative market. Vitalii Naishul's (1993) disapproval of any plans for privatization in Russia was based on the assumption that privatization would take property away from those who already own it:

> 'Privatization is unnecessary and harmful because in fact it means a redistribution of property: a forced confiscation by the state of legal entities' property rights and the transfer of these rights to other persons in line with a plan worked out and implemented by bureaucrats.'

This, according to the interpretation offered here, was naturally exactly what did not take place. Larisa Piyasheva, another prominent liberal, also had little understanding for what was going on. Commenting on privatization legislation she commented that '... under no circumstances will the employees of an enterprise have controlling interest in it. ... This virtually deprives employees of the opportunity to ... become independent of administrative command" (Piyasheva 1994: 79).

Whether insiders are willing to dilute their dominant position is one question. Whether the market through which ownership transfer might take place exists, is another. We now turn to the second question. Russian equity markets exist, have grown fast in both volume and value, but have also proved highly volatile. Reports on violation of outside minority holders' rights are frequent but at least in some cases also well-published. The privatizers of Russia are naturally well-aware of these problems, and the best economists among them, fully knowing that 'the real work has only begun' (Shleifer and Boycko 1994) have listed six major challenges ahead: (1) transition to cash privatization - to provide enterprises with revenue to address problems of restructuring and for other reasons; (2) corporate governance and legal reform - to facilitate outside investment; (3) creation of securities markets - for reasons obvious in the light of previous discussion; (4) land and real estate reform, (5) competition policy; and (6) the creation of a non-plant specific social safety net.

What can surely be argued is that there has been too little and too late emphasis on the kinds of institutions that are needed to make the Coase Theorem a possibility in Russia (Blasi *et al.* 1996). Our knowledge of secondary markets for property titles in Russia is highly deficient. No proper over-all statistics exist on most of the interesting questions. In a country with highly deficient, if any, share registries, custodial and clearing services nobody can no for sure who owns what and what is actually being traded between whom. Clearly, even what is claimed by Russian authorities as fact is usually nothing more than a result of partial studies, sometimes even less. Still, many of the enterprise level examples highlighted in Russian and Western press are illustrative, even if often somewhat extreme cases. Enterprise managers remain sometimes ignorant of actual stakeholders until annual shareowners' meetings. The names of legitimate shareowners may be simply wiped away from registries. Managers secure their position through targeted share issues without informing other owners. They also, somewhat routinely, withhold relevant information from outside investors. Managers often, it seems, have priority buying rights in case an employee wants to sell his/her shares. Not knowing who the actual owners are in each case, the media creates further uncertainty by speculating freely on share trading, especially when strategic issues are deemed to be involved.

So far, empirical research clearly indicates that though many privatized enterprises had started to shed excess labour, to adjust their output mix according to demand and to introduce trade and service activities, there is still no proper distinction between the voices of management, labour and capital. This should be seen as constituting a problem not because managerial capitalism with an employee voice is automatically a bad thing, but because there should exist a consensus that given the Russian background, such a combination comes all too close to maintaining all too many of late Soviet peculiarities.

Some of the issues of developing securities markets and legal reform are basically technical and simple. If we have any trust in the possibilities of Russian infrastructure development, they should not be a major hindrance to development. Indeed, by mid 1997 crucial market infrastructure already exists, and though much still remains to be done the trend is clearly towards the better. The important registry, custodial and clearing systems, in particular, are evolving. The crucial question will no longer be if the basic market infrastructure exists, but if the will to use it is there now that the insiders have had time to learn and live the rules of their making.

For the time being, enterprises clearly give share issues only little importance in raising capital. Why? Mainly, it seems, because there is only little interest in long-term finance in general while short term bank credit has often been readily available at practically no cost. Existing taxation also tends to make share issues a very expensive way to raise capital.

Other well-known problems include the existing bankruptcy procedure, which is seldom used and anyway gives too much power to a government agency. Debt is unlikely to become an effective control device. Boards of management are usually dominated by insiders. Although the equity market is developing fast, it is highly concentrated on a small number of enterprises - usually the same fifty-odd that foreigners are interested in. There seems to be no market for the shares of something like 90 per cent of all privatized firms. Almost 90 per cent of actual trade takes place off the official markets.

To the degree that Russian enterprises will want to invest, and government money will not be available, demand for investment finance should be great. In most cases, managers will not have the money, and large scale foreign investment looks improbable for several reasons. There is no reason why investment from retained earnings made through capital that has been inherited free of charge would lead to a competitive productive structure. Therefore, the first crucial issue will concern the relations between enterprise insiders and the money accumulated through Russian trading and financial capitalism. Potentially, the supply of investment finance should be sufficient. Estimated tens of billions of dollars have been accumulated both abroad and at home. Much of this money is in liquid assets and therefore technically easy to mobilize. This is what most Russian reformers put their hope on as they aim at developing both primary and secondary capital markets. In the first phase, the sale of remaining state-owned shares - about 10 per cent on average - in investment tenders or otherwise has been intended to become the great spurt for capital market development. So far the second phase of Russian privatization has not lead to greater inflow of outside money to enterprise investment.

Privatizers like Vasiliev have long argued that because of the peculiar history and structure of Russian banking, where in-house wildcats banks dominate numerically, the Continental model of bank-centred financial system is singularly unsuitable for Russia (Shleifer and Vasiliev 1994). Therefore, they aimed at conspicuously fairer and more transparent capital markets than the banking system is. The loans-for-shares scheme was one of the tests of this approach. Another crucial question concerns the future fate of the tenth of shares still remaining in state ownership: are they also to be transferred to the banks, or might they create another boost to widely spread ownership and liquid capital markets?

Overall it seems that the call (Frydman, Pistor and Rapaczynski 1995: 108) for ‘an effective (and perhaps in part coercive) state intervention’ to open Russian companies to outside influence will not be heeded by the present authorities. Other things being equal, therefore, one would expect further development towards a bank-centred system. Though the boasts of Moscow bankers that seven of them now control half of Russian industries[18] are not supported by publicly available information or by enterprise surveys (Table 5), integration between Russian financial and industrial capital is proceeding swiftly (Mizobata 1995). At the same time, open banker influence upon Russian high politics has become notorious. On a less visible level, leading banks and the authorities share a common interest in such institutional and policy development that would both secure the systemic stability of the banking system and availability of market finance to finance endemic budget deficit. This should be available on terms that are sustainable both fiscally and from the investment finance point of view. Given fast monetary stabilization, a high degree of dollarization and a seemingly fragile banking system, this equation is not easy to solve and will preoccupy Moscow politics for quite some time.

Overall, insider dominance will remain important in Russia. This, in combination with financial-industrial integration, makes up the basis of a very peculiar Russian capitalism. Currently, fighting over the control of boards of possibly all the largest enterprises is on, and in many cases closely followed not only by those directly involved, but also by the media and the international institutions. This creates a degree of openness in the process, and outside attention seems to have made an impact in some cases at least.

VI CONCLUSIONS

Several conclusions offer themselves. First, and quite clearly, there is no single correct method of privatization. The actual outcomes of different privatization paths are still unclear, as secondary and tertiary redistributions of property titles continue, and the time needed for the privatization-restructuring-performance links to work themselves through

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[18] *The Financial Times*, 1 November 1997.

is not yet past. In fact, information on actual ownership arrangements is often scarce and perhaps unreliable. Mass privatization has become increasingly frequent - especially in countries where competitive plants have perhaps already been sold - and is widely applauded. On the other hand the privatization outcomes in, say, the Czech Republic and Russia differ sharply from the ones originally expected. Hungary has perceived no need to engage in mass privatization, and at least some proponents of slow privatization also feel themselves vindicated.

Second, all countries combine in practice different methods. The name of the game has been multi-track privatization.

Third, the initial conditions of each country did matter. That concerns the extent and character of de facto stakes in firms held by different groups, the availability of foreign investment, the need for restitution and other aspects, including the characteristics of the political process.

Fourth, the private sector grows independently of the methods and extent of privatization. The variability of new entrepreneurship across countries is not yet well understood.

Fifth, privatization outcomes cannot be planned. In several cases, the outcomes diverge steeply from original expectations. The extent to which privatization was originally planned as social engineering also differed across countries.

Sixth, insider ownership predominates in most countries. State ownership remains important. Though financial systems are generally closer to the Continental than to the Anglo-American system, the relative scarcity of bank capital often limits the role they can play. No country has true popular capitalism of widely and evenly spread ownership. The border between public and private property is often unclear.

Seventh, privatization is beginning to make a difference to enterprise behaviour and new private firms are radically different also in Russia.

Finally, privatization is not yet over. What will be done with remaining state property is of importance, so is the development of secondary markets in property titles. The political authorities have the crucial responsibility in most aspects. True, any form of privatization may be better than negligent state ownership. But that only implies that no negligent state ownership should exist.

Where does our discussion take us concerning the two fundamental economic reasons for privatization distinguished above? The view underlying this paper is captured by the two captions on the first page.

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