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**ACCELERATING PRIVATIZATION IN EASTERN EUROPE:
THE CASE OF POLAND**

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Accelerating Privatization in Eastern Europe: The Case of Poland¹

I. Introduction

The need to accelerate privatization in Eastern Europe is the paramount economic policy issue facing the region. If there is no breakthrough in privatization of large enterprises in the near future the entire process could be stalled for political and social reasons for years to come, with dire consequences for the reforming economies of the region. It should be the main job of the international institutions such as the World Bank and EBRD to help accelerate the process of privatization by providing urgently needed financial and technical support for the key operations of mass privatization. The operating guidepost of the World Bank should be that privatization is urgent -- and politically vulnerable -- and that privatization should almost always precede restructuring, at least for industrial enterprises.²

¹Much of this paper is based on joint work with David Lipton. I would like to thank the World Institute for International Economics Research (WIDER) for generous support.

²The Government of Poland has enunciated a basic policy that enterprise restructuring should in most cases follow privatization, and be taken at the initiative of the privatized enterprise. Nonetheless, within the bureaucracy there are powerful groups arguing that many enterprises should be restructured as a prelude to privatization. The World Bank should be constantly on guard lest its support for restructuring policies inadvertently play into the hands of bureaucrats trying to reassert their influence over the economy. (Since the World Bank itself has a past tradition of encouraging government-led sectoral policies, some self-policing will be vital here).

It should be noted that in Eastern Europe, most of the privatizations in the next couple of years will involve industrial

The details concerning privatization differ throughout the region, though the political vulnerability of the process and the consequent need for rapid action are common to all of the countries. The countries differ in the scale of efforts that are needed, the specific nature of the political conflict over privatization, and the extent of progress that has been achieved to date. Since it would be impossible to cover the entire region comprehensively and accurately, I choose instead to focus on a single country, Poland. The paper is an update, after six months, of the discussion in Lipton and Sachs (1990).

The Current Situation

The situation in Poland regarding privatization is as follows. The basic privatization law was passed in July 1990, and the Ministry of Ownership Transformation (MOT) was set up under the new law. Since the introduction of the law, small-scale privatization of shops and other small service units has proceeded very rapidly (usually under the authority of local governments), with an estimated 60,000 shops either leased or sold to the private sector during 1990 and 1991. Another few hundred thousand totally new

firms that are already subject to domestic or international competition. (The most egregious cases of multi-plant monopolies in Poland are in the process of being broken up under the authority of the Anti-Monopoly Agency). This situation differs from that of the U.K. in the 1980s, where many of the privatizations involved (alleged) "natural monopolies," such as telecommunications, railroads, or public utilities. In those cases, privatization also required an accompanying regulatory policy for the newly privatized firms. In Eastern Europe, privatization of telecommunications, utilities, railroad transport, and the like, are generally being put off until later in the privatization process.

private establishments in the service sector have also been started from the ground up.

As a result of the small-scale privatization, around 70 percent of retail trade is now in private hands, and wholesale trade is rapidly being taken over by the private sector. Truck transport has also been substantially privatized (it is estimated that more than one half of the trucks in the country are in private hands). Privatization has also proceeded rapidly in domestic wholesale trade, international trade, and construction. Moreover, there are now an estimated 1,312 joint ventures between foreign firms and Polish enterprises (in many cases, Polish state enterprises), which have also contributed to the partial privatization of the economy. Agriculture has long been about 75 percent privately owned.

In industry, however, the situation is far less bright. Of the estimated 3,107 industrial (mining or manufacturing) enterprises in the state sector, only about 100 to 150 have been privatized to date. The main method, used for medium-sized enterprises (of around 500 employees or fewer) has been leveraged buyouts by workers, in a process termed "liquidation" by the Polish authorities.³ Another 7 were privatized at the end of 1990 through "traditional methods": 5 large firms through initial public offerings, one firm through a trade sale, and one firm through a

³This term is used because under the process, the old state enterprise is terminated and a new enterprise (owned by the worker and management) is established based on the property of the old enterprise.

management buyout. Some dozens of other state enterprises have been partially privatized through joint ventures with foreign investors. The great majority of the large-scale industrial enterprises remain in public hands. It is also estimated that around 6,400 private industrial firms are now in operation. Overall, probably three-fourths of industry by value added remains in state hands.

While nobody has yet made a careful assessment of the extent of private ownership in Poland, it is probably the case that up to 40 or 45 percent of the economy is now in private hands. This estimate is a bit higher than usual, but it tries to take into account that a significant amount of private economic activity is currently unmeasured by the official statistical agencies.

In addition to actual privatization, the legal basis for private capital ownership has also improved, with the establishment of the stock exchange (opening this month), and new securities laws and foreign investment laws. Land ownership rights have also been clarified in legislation this year. The government has recently approved plans in April 1991 for the privatization of the banking system, with two or three of the nine state commercial banks targetted for privatization during 1991. Also, around 100 enterprises have been commercialized, that is converted to joint-stock company form with 100 percent Treasury ownership.

The government has also made a clear policy commitment to rapid privatization in the next five years. The intention is that by the end of 1993, more than one half of the 7,000 state-owned

enterprises will be in private hands, and that by the end of 1995, the economy will have an ownership structure similar to that of Western Europe.

The dangers of the current situation

The gross economic inefficiencies arising from the socialist ownership structure are widely understood in Poland, and have prompted the government's bold privatization goals. Nonetheless, there remain enormous risks to the process of privatization, and a real possibility that the process could still become paralyzed. These risks underscores the urgency of making a breakthrough in the privatization process in Poland this year.

First, there is the risk of renewed macroeconomic instability, that could derail the entire reform program. In the current circumstances, the wage pressures are unrelenting, and threaten a renewal of a wage-price spiral and large budget deficits. Workers and managers in the state enterprises constitute a coalition to maximize the short-run income. There is no internal wage bargaining, since the managers (often elected by the workers) tend to side with workers in wage disputes with the government. It is only a slight exaggeration to say that the Finance Minister is the only man in the country that actively fights for wage restraint. And this is clearly an untenable position: he reports not to a board of directors, but to the voters. Not surprisingly, the government's brave and correct incomes policy vis-a-vis the state enterprises has become the focal point of public protest and

opposition to the government's policies.

Second, there is the risk is that political parties will try to get their tentacles around the state enterprises in Poland. As the Italians, Argentines, and so many others have amply demonstrated, the state enterprises can be a seemingly bottomless gold mine for patronage and party financing.⁴ The political parties will find an active base of support among constituencies in the bureaucracy, and among enterprise workers and managers, all of whom are stakeholders in the enterprises and are resisting privatization except when the privatization includes an adequate sidepayment (such as equity participation, guarantees of future employment, debt relief for the enterprise, and so on).

Third, there is the risk that privatization will become increasingly associated in the public's mind with unemployment, thereby forcing the government to scale back its plans. It is inevitable that major political parties will begin to champion the cause of "slow" (or no) privatization, together with government-led bailouts of firms, as an electoral response to widespread fears of

⁴Privatizers should take heed of the recent dire conclusions of the Financial Times regarding Italy. John Wyles writes:

The reach of the political parties is extraordinary in Italy, and has lengthened in the post-war period because of the republic's inheritance of a vast system of publicly owned banks and industries. Few impartial observers see how this public sector can be sustained in the 1990s as it encounters the fundamental constraints of EC rules and Italian public debt. (Emphasis mine)

(Financial Times, April 6/7, 1991).

rising unemployment. The German government is already stepping back from rapid privatization in response to the burgeoning unemployment in East Germany, even though that unemployment is caused by excessive wage settlements rather than privatization per se.

Similar political pressures against rapid privatization are likely to build in Poland. A hint of this is seen in the recent policy statement of the important ROAD Club, a Solidarity-based political group composed of supporters of former Prime Minister Mazowiecki. While the statement is ambiguous, it is worrisome in its seeming endorsement of worker self-management rather than privatization.⁵

According to the club, because state-run enterprises will prevail in Poland for the next ten years, a plan to ensure their efficiency should be drawn up. The club proposes to turn these firms into joint-stock companies of the state treasury, which will be later transformed into regional holding companies in competition with each other. They should be entitled to stock turnover and to property transformations. The companies would be controlled by the workers, through representatives on the supervisory boards. (Emphasis added)

Fourth, there is the risk that other constituencies will also slow the process of privatization. Former owners of property are pressing for restitution of former property, even though a widescale process of restitution (or "reprivatization") would surely end up with a mountain of lawsuits fighting over unclear property rights based on claims one-half century old. Nonetheless,

⁵Reported in The Insider, as a reprint from the Zycie Warszawy.

many former owners are wealthy or politically connected, so that the issue of restitution remains a potential trap. Ironically, foreign investment bankers also constitute an important "interest group" since they know that standard British-style privatization -- based on detailed valuations of enterprises, followed by public offerings -- promise a mountain of fees, even if the method is too slow to be the basis of privatization in Poland.

For these reasons, the issue about privatization is not simply one of pace, but one of guaranteeing that it will be accomplished at all. If privatization proceeds too slowly in the next year, macroeconomic instabilities -- especially caused by explosive wage demands -- could well reoccur. At the same time, opportunistic behavior by political parties as well as resistance by entrenched interests could begin to tighten the noose around the privatization process. The combination of macroeconomic instability, political resistance, and opposition at the firm level, all together could prove deadly to the privatization effort.

These fears of paralysis are not yet widely shared. There is a false sense of security -- both inside Poland and in the international institutions -- about the continued progress on privatization. The general sense of wellbeing on this issue arises from two main factors.

First, Poland's economic policy has been governed since 1989 by a brilliant technocratic team under the leadership of Deputy Prime Minister Balcerowicz. So far, the reform effort has been guided by technical solutions rather than partisan politics. But

this has not been a period of normal politics. Organized political parties and lobbying groups barely existed when the post-Communist government took office in September 1989, since the Communists had virtually destroyed all organized groups in the society. It is inevitable, however, that "normal politics" will once again dominate the policy process, and the scope for decisive policy actions will be greatly circumscribed.

Rent-seeking behavior will grow dramatically as political parties and interest groups get better organized, and the privatization process will become increasingly politicized. Moreover, given the likely adoption of a proportional representation system in Poland (and the rest of Eastern Europe), political parties will probably be vying for a place in a multi-party coalition government. Poland's own pre-war history and recent cross-country research has shown that multi-party governments are especially prone to parliamentary paralysis. The complications of coalition politics are illustrated in Hungary where the small coalition partner, the Smallholders Party, is pressing hard for restitution of nationalized property even though it is widely believed among experts inside and outside of Hungary that a policy of restitution could gravely threaten the overall privatization effort.⁶

⁶The fear is that restitution will open up an endless stream of lawsuits challenging the title to particular properties. Not only will the properties directly affected by claims lack clear ownership for years to come, but investors will also be reluctant to proceed with purchases of other properties for fear that they too will become embroiled in restitution claims at a later date.

Another reason why the privatization process is generally believed to be "on track" is the accurate sense that much is changing rapidly in Poland. Virtually every day the press reports another enterprise that has been prepared for privatization, or that another joint venture has been started. Since more than 60,000 small shops have already been privatized, as well as hundreds of medium-size enterprises through worker-management purchases or joint ventures, the forward progress seems to be marching forward with inevitability. Yet since the large enterprises are as yet largely untouched by privatization, the sense of progress is overstated.

II. Methods of Rapid Privatization

Several methods for speeding privatization have been suggested, and a variety of techniques will have to be employed to guarantee that the government meets its targets. Each one will require an improved management capability of the government, and international technical assistance. But most of all, it will require the concerted intention of the Polish government to make a breakthrough in the near future -- before this special opportunity for decisive action drifts away.

The original intention among many senior officials in the Privatization Ministry in Poland was to carry out the process of privatization mainly through initial public offerings (IPOs). This was also the view of key international institutions. One advisor brought by the International Finance Corporation informed the

Polish government in mid-1990 that new techniques of public offerings would allow the government to privatize hundreds of large enterprises through initial public offerings in a single year. The idea was to sell enterprises in "bunches" of around 20 per month every month. A team of international investment bankers would work rapidly to carry out the enterprise valuations as a prelude to the bunched privatizations.

The attempt to rely mainly on IPOs was predictably flawed, even though it was urged upon the government by dozens of investment banks used to that method of privatization. IPOs are always time consuming, and local circumstances suggested that they would be especially difficult in Poland, where there are no capital markets; no domestic investment banks; a stock exchange only beginning operations in April 1991; no reliable basis for the valuation of enterprises; low levels of household financial assets with which to purchase shares; and thousands of enterprises to privatize.⁷

⁷Consider merely the question of the public's financial holdings, for comparison with the capital value of the industrial enterprises. The post-tax profits of the largest 500 state-owned firms are approximately \$5 billion. With a price-earnings ratio of 5, the capital value of the largest 500 firms is around \$25 billion. The public's financial holdings in the banking system total approximately \$10 billion, only forty percent of the capital value of the largest firms at the modest P-E of 5. And taking into account that other property in addition to the 500 large enterprises is also to be privatized, it is clear that in order to privatize through IPOs, the share prices would have to be at very low price-earnings ratios, which in turn would risk a socially unacceptable concentration of share ownership. The alternatives are to transfer the shares to the public freely by some means (as recommended below); or to sell the shares on a leveraged basis, which would pose its own risks and complications.

In the summer of 1990, the government had the intention to privatize around 20 enterprises by IPOs during the second half of 1990. In the fall, this was scaled back to 5 enterprises. These enterprises were offered for privatization via IPOs in December. When the shares were undersubscribed for some of the firms, the closing date was extended to early January. In the event, only three of the five enterprises were fully subscribed by the general public; the shares of the other two were purchased by a new state development bank in order to complete the IPO.

The valuations of the five companies had taken several months and had cost about \$4 million in fees to the foreign investment banks, and several millions of dollars more in success bonuses. The baseline fees to the investment banks was about 12 percent of the sales price of the firms (around \$31 million in tendered shares, some of which were bought by the state bank). With bonuses included the overall payments probably constituted around 25 percent of the value of the five companies. One of the three companies that had been completely subscribed, the Krosnienskie ("Krosno") Glassworks, quickly fell into serious financial difficulties after the public offering, and it expected that its share price will decline significantly in secondary trading when stock market trading begins later in April.⁸

⁸There is of course nothing wrong with a decline in the secondary market price except for the fact that the government had deliberately set the prices low in order to encourage capital gains and subsequent enthusiasm in the public for share purchases. Even when the government tries to pick five "winners" out of hundreds of firms, it turns out to be hard to do.

As a result of this expensive and time-consuming experience, the Ministry of Privatization has recently and wisely cut back its plans for the rate of IPOs. The Privatization Minister has recently announced that Poland will not continue with bunched sales, but will instead conduct IPOs on a one-by-one basis. It is now assumed that at most a few dozen enterprises will be privatized through IPOs during 1991.

Transferring Ownership to Insiders

A far simpler method of privatization is to transfer the ownership of the enterprises to the insiders, that is, the management and workers in the firms. This can be done rapidly through direct giveaways, leverage buyouts, or some combination (leveraged buyouts at concessional prices). Indeed, it would be possible, were it desired, to give away the entire enterprise sector to the current insiders in a very short period of time. Transfers or sales of shares to insiders should be widely employed -- and more widely than is now the case -- but should be subject to clear standards and limitations.

One key problem here is fairness. While insiders should surely receive some explicit property rights in their enterprises to compensate them for their current implicit property rights, a complete transfer of enterprises to the insiders at very low prices would unfairly benefit the insiders relative to the rest of society. The work force in state industrial enterprises totals about 3.6 million workers in a labor force of 18 million, and a

population of 38 million. Some workers are in highly profitable enterprises while others are in bankrupt enterprises.

Another problem with insider privatization is efficiency. In general, worker ownership is desirable neither for the workers, who should diversify their capital not concentrate it, nor for the capital structure of the firm, which should have outside owners as well as inside owners. A firm owned mainly by its workers tends to be isolated from the capital markets, since potential outside investors are concerned that inside owners (who control the firm) will appropriate the profit stream. Worker owners, for example, will have the incentive to push for excessive wage increases at the expense of the outside investors. These efficiency concerns are of greatest consequence in large, capital-intensive enterprises that must participate in the capital markets and that aim to trade in the capital markets. The concerns are probably of little consequence in small, labor-intensive enterprises. There is also no risk from a small, non-controlling proportion of share ownership by workers, say 20 percent of the shares widely disbursed among the workforce.

The public's outrage against spontaneous privatizations by managers, and the economic team's worry about worker ownership in the large enterprises, led the government in 1990 to resist insider privatization in favor of outsider privatization via public offerings. But the reactions probably went too far. The simplest methods of privatization -- direct sales or transfers to the insiders -- have been underutilized, while the harder methods (such

as IPOs) have been overemphasized.

The Polish Privatization Law passed in July 1990 attempted to allow for, but to strictly limit, insider privatizations. The law allows for a limited concessional sale of shares to workers. Specifically, workers are entitled to buy up to 20 percent of the shares of the enterprise at half price, subject to the proviso that the total value of the concessions to the workers (the half price times the number of shares purchased) must not exceed one year's wage bill of the enterprise.⁹

Since the law calls for sales at half price, and the Polish privatization authorities have interpreted this to mean a "market price," the concessional sales approach has so far been employed only in cases when the firm is being sold by some other method. In the five IPOs undertaken at the end of 1990, for example, the workers purchased 20 percent of the shares in each case. Thus, the concessional transfer of shares to the workers has so far played no role in speeding the process of privatization.

If the law had simply granted the workers ten percent of the shares for free, then the direct transfer of shares to workers could have been used to speed the privatization process without the agony of determining the "price" of the shares. And even if the

⁹As an example, suppose that the enterprise shares are valued at \$100 million. A sale of 20 percent of the enterprise shares at half price would mean a sale for \$10 million. If the annual wage bill is greater than \$10 million, then the law authorizes purchases by workers of the full \$20 million of shares for \$10 million. If the annual wage bill is only \$6 million, say, then the law entitles the workers to purchase only \$12 million of shares on a concessional basis (12 percent of the enterprise), at the half price of \$6 million.

government sticks with the plan to make concessional sales to the workers at half price, it could still choose to use the book value of the enterprise, rather than a market price, as the basis for the sale of shares to the workers.

Since the start of 1991, there has been a promising advance in insider privatization for medium-size firms, generally of about 500 employees or less. The government has approved about 100 leveraged buyouts by worker-management groups of these relatively small firms. The worker-manager group seeking the enterprise buys the enterprise with an up-front payment of about 20 percent of value (based on a quick outside valuation that in fact relies heavily on the book value). The rest of the enterprise is purchased with a loan from the government, that is to be amortized over several years. This process has been given the misleading label of "liquidation" in the Polish privatization parlance, since formally the state enterprise is liquidated and the property of the enterprise is transferred (in its entirety) to the new worker-owned entity.

Outsider Privatizations

The government has wisely operated on the premise that outsider privatization (sales or transfers of shares other than to workers and managers in the enterprises) will be the key method for privatization of large industrial firms. There are four different groups of outsiders who can own shares: small investors in the general public; foreign investors; financial intermediaries (banks,

pension funds, mutual funds), whose shares in turn would be owned by the general public; and other industrial enterprises.

The government's original hope was to transfer shares to the general public mostly through IPOs, a process that has proved, predictably, to be one of frustration. As already noted, the public has limited savings, and lacks experience with share ownership. Moreover, prudent share ownership by the public requires a set of institutions (the stock market, securities laws, regulatory oversight, institutional means to diversify risk, and so on), that is only now coming into existence.

Foreign investors are another important potential source of outside investors, but here too, the process of privatization is currently fraught with difficulties. Not only is it politically untenable to privatize the economy mainly by sales to foreigners, but the current arrangements for sales to foreigners are particularly troubling. The potential foreign investor faces two paths, joint ventures and outright purchases, each of which involves a distinct and somewhat vague structure of bargaining. In both cases, the foreign investor must generally negotiate with the manager of the enterprise, the workers council, and the government. The fact that the potential investor must negotiate with the enterprise management virtually guarantee that bad offers may get accepted while good offers get rejected.

A manager naturally considers a foreign bid from the point of view of the manager's own future management role and also whether they he will get a "cut" of the action in the takeover. The

workers' council is of course mainly interested in guarantees of future employment and wage levels. Neither the manager nor the workers' council has much obvious interest in the capital value of the offer itself. Managers might accept low bids for the firm if they receive a cut of the action, while they might turn down good bids that might lead to the replacement of the manager. It is as if takeover offers in the U.S. were to be accepted or rejected by managers and workers rather than by shareholders (or by the board of directors acting on behalf of shareholders).¹⁰ While the MOT can in principle override the decisions of the enterprise manager or workers' council, this may be hard to do in practice given political constraints, or simply given the difficulty that the MOT has in monitoring the huge number of firms in the enterprise sector.

Clearly, what is needed is a procedure that would put an individual or group with fiduciary responsibility (such as a trustee for the Ministry of Ownership Transformation) in the legal position of the board of directors in a U.S. firm, to consider the adequacy of a foreign bid, and to generate competing offers according to a well-defined timetable (more on this below).

Financial intermediaries as outside investors

¹⁰In the U.S., court decisions regarding takeovers have gone to some lengths to guarantee that the takeover offers are judged by boards of directors according to the interests of the shareholders of the firm, not by the insiders. Speaking crudely, after a takeover bid puts an enterprise "in play," the board of directors is obligated to try to obtain the highest bid for the firm.

In most advanced market economies, more than half of the equity is owned by financial institutions, including banks, pension funds, and investment trusts (or mutual funds). The capitalization of financial intermediaries offers an enormously promising way to proceed with rapid privatization, though this method is almost wholly unexploited to date. (See Lipton and Sachs, 1990, for a more detailed discussion of the proposals in this section).

There are certainly complexities in creating new financial intermediaries in Poland that could receive shares in the enterprises, but these complexities have been unnecessarily magnified by the Polish government in its consideration of privatization via financial institutions. There is still an opportunity to make rapid progress in this area.

The most important opportunity lies in share ownership by commercial banks, as in Germany and Japan. Poland has nine state-owned commercial banks that dominate the commercial banking market (around 50 new private commercial banks have been licensed, but most of these banks are still very small). These state banks are in the process of being converted into joint stock companies for subsequent privatization, and the government is aiming to privatize two or three of the banks this year. One method of partial privatization of industrial enterprises would be to give the commercial banks part of the industrial equity prior to the privatization of the banks. The valuation of the banks at the time of their privatization would reflect the portfolio of corporate equities held by the banks at that time.

The case for giving shares to the banks is very strong. Since the banks are the one existing financial institution in Poland capable of holding and managing corporate equities, it would be natural to use them for this purpose. Moreover, a growing body of international evidence and theoretical reasoning points to the conclusion that banks are excellent candidates for share ownership in that they provide particularly effective corporate governance.¹¹ Banks in Germany and Japan develop intimate relationships with their corporate clients based partly on their equity holdings in the corporations to which they lend.

The close relationship with of industrial enterprises and banks is especially important when other capital markets, such as bond markets, are relatively weak, as was the case in post-war Germany and Japan at least until very recently. In such a circumstance, industrial enterprises depend importantly on long-term bank loans for capital investments. In Poland, it is likely that long-term bond markets will remain relatively undeveloped for several years, so that bank lending will play a predominant role in the economy.

In general, the equity holdings of the German and Japanese banks are not of a controlling amount, but are enough to give the banks a seat on the board of the industrial enterprises, and to

¹¹The finance studies stress that bank ownership of corporate equities tends to foster a healthy long-term relationship between the banks and the industrial enterprises, a relationship that contributes especially to a long planning horizon of the industrial enterprises. See, for example, the favorable discussion of universal banking in Cable (1985), Aoki (1988), and Hoshi, Kashyap, and Scharfstein (1990a,1990b).

scrutinize management decisions, especially when the enterprises are in financial trouble.¹² To use a popular parlance, the banks tend to use "voice" in troubled enterprises while other kinds of institutional investors tend to use "exit."

Many Polish officials have argued the Polish state banks are not effective enough to exercise the role of corporate governance. They point out that the banks can barely clear checks, much less help to guide industrial firms. This is a plausible but ultimately unconvincing argument. Under any circumstances the banks will have to be greatly improved if the Polish economy is to function well. Even without entering into equity ownership of industrial firms, the banks are going to have to understand clearly the state of the industrial enterprises simply to make their basic credit decisions. A major effort in Poland will therefore have to be made to improve the functioning of the banks. That effort indeed has already started with the participation of the World Bank, the IMF, and several central banks. It would not take much to extend the bank rehabilitation program beyond credit analysis to include rudimentary capabilities of corporate governance.

A second rapid way to privatize shares via financial institutions would be to capitalize pension funds using the Treasury's shares. Under current arrangements, pensions in Poland are paid entirely by the government on a pay-as-you-go basis

¹²In Germany, the power of the banks extends beyond direct ownership, since the banks also tend to vote the proxy shares of individual shareholders who deposit their equities with the banks.

financed by a payroll tax. This system could be partially privatized along the lines successfully carried out in Chile in the early 1980s. The Government would deposit a proportion of its equity ownership into several new portfolios, each of which would be managed as a private pension fund by a portfolio management group licensed by the government. As a rough illustration, 20 percent of the corporate equity of the top 500 enterprises could be deposited into five funds, each receiving four percent of the enterprise shares initially (after which the shares would be tradeable by the pension fund managers). A portion of the industrial workforce would then be transferred from the public system to the new private system. After the worker is transferred from the state system to the private system, the worker's payroll tax would be converted into a contribution to one of the new private pension funds.

It would probably take several years to phase in such a system. Careful preparations would be needed to account for budgetary effects of the changeover from a public, pay-as-you-go system to a private, funded system, and to protect the pension benefits of the workers as they join the new system. Decisions would have to be taken carefully regarding the freedom of entry of new pension plans. Nonetheless, part of the process could start quickly, with the allocation of equities to the new pension funds and the licensing of pension fund managers. Hooking up the workforce to the pension funds would take more time, but could be accomplished after the funds themselves are set up.

A third way to privatize through financial institutions would be to give households claims to investment trusts (closed-end mutual funds) set up with the Treasury's equities. According to this widely discussed idea, which has been endorsed by the Government of Poland and is now in the design stage, the Polish government would license several investment trusts -- known as Polish Management Funds (PMFs) -- and would freely distribute its industrial share holdings to these funds. The PMFs themselves would be divided into shares, and these shares would be freely distributed to the adult population of Poland. In current discussions in Poland, about 30 percent of the equity of several hundred large corporations would be included in this process.

The specific design of the PMFs has been heatedly debated. There are several practical areas of disagreement. Should individuals have the choice whether to receive individual shares of enterprises or shares of a PMF? Should individuals be able to choose their PMF? Should the funds be mostly passive investors, trading equities but not being involved in the corporate governance of the industrial enterprises? Or should the funds be allocated the controlling interests in individual enterprises, so that each investment fund plays an active role in the corporate governance of the enterprises that it holds? Should the households be able to trade their shares of the PMFs without restriction, or should there be a period of time (say, one year) in which they must hold on to their claims? Should the PMFs be able to trade the industrial shares that they hold immediately, or should they be required to

hold on to the shares for a given period of time? How should the PMF managers be compensated?

The predilection among Polish officials is to create a system of maximal choice for households and the funds. For example, one popular notion is that households would not receive investment trust shares directly, but instead would receive voucher coupons that could be used either to buy equities in individual enterprises or to buy a share in an investment fund. In that scheme, the investment funds would receive vouchers which they would then use to bid for shares from the government, so that the PMFs would have a key role in building its own initial portfolio of shares.

It is also popular among many Polish officials to envision that the investment funds would have controlling interests of industrial enterprises -- in some proposals a PMF could hold up to 100 percent of the equity of an enterprise. There is naturally a desire among Polish officials to create powerful ownership groups, modelled on venture capital funds, that could play a key role in restructuring the state enterprises. The investment funds are widely looked upon as the institutions to carry out such a function.

I would strongly opt for a far simpler system, with much less choice at the outset, and with weaker funds, in order to minimize risks and to save enormous administrative complexities. The process of creating investment funds will require the prompt distribution of shares to 25 million adult Poles in a situation in which there do not now exist any tested institutions of share

ownership, brokerage houses, or even established investment funds.

In the interest of simplicity, I would recommend that individuals be randomly assigned to investment trusts without any choice (e.g. based on the number of their national identity card). In turn, the Treasury's shares would be randomly allocated to the investment trusts, again with no choice. There would seem to be little gain to expending great efforts in auctioning the shares to the investment funds when these funds will be free to trade their initial allocations after they are received. The initial allocation of shares should be designed administratively to meet two criteria: equality across fund-portfolios in the reported post-tax earnings in 1990 and equality of the book values of the enterprise shares held in each fund. Subsequent to this initial distribution, the investment funds would be allowed to trade their shares.

I would also strongly recommend against allowing the investment funds to gain a majority stake in individual enterprises. In fact, in my view, the ownership of any enterprise by any PMF should be limited to 10-15 percent of the shares of the enterprise. Even though it might seem attractive to create powerful active investors, this should not be done artificially with newly established investment funds that have no management track record and that do not even have the fund managers' own money at stake.

The risk of allowing the investment funds to have controlling interests of a large number of enterprises is magnified by the fact

that the funds would receive the shares of a significant proportion of the industrial sector. If the funds are allowed to gain controlling interests of enterprises, the result could be to create very powerful holding companies that could be anti-competitive and that could block the development of the capital markets for the industrial firms (it would be impossible, for example, to mount a hostile takeover of an enterprise if more than half the shares are held in a PMF).

Simply put, the risks of creating powerful holding companies is too great and the potential gains are too small. The desire for holding companies also reflects a widespread misunderstanding in Poland about the nature of share ownership in publicly traded companies in the West. It is commonly and wrongly believed that most publicly traded corporations have a dominant owner that guides the corporation. In the vast majority of large publicly traded corporations, however, there is no single controlling interest. In the United States, the largest five shareholders of major publicly traded corporations usually hold much less than 50 percent of the shares. In a sample of large U.S. corporations reported by Demsetz and Lehn (1985), the largest five shareholders had less than 25 percent of the shares of an enterprise in the case of 60 percent of the corporations, while the top five shareholders had less than 50 percent of the shares of an enterprise in the case of more than 90 percent of the corporations in the sample.

III. Operational recommendations for accelerating privatization

If the Polish government adopts simplified procedures, there is still time to accomplish a massive privatization of industry before the political and social resistance dangerously slows the process.

For small and medium-sized firms, say with less than 1000 employees, the preferred form of privatization should be some form of worker-management buyouts, on a leveraged and concessional basis (similar to the "liquidation" procedure now in use in Poland).¹³ All small firms should be put on notice that during a short time interval (say, six months) they may organize a leveraged worker-management buyout on highly concessional terms spelled out by the government. Certain basic procedures would have to be followed in the design of the buyout (such as the right to participate for all members of the workforce on equitable terms).

In the case that no group of workers and managers chooses to purchase the firm during the allowed period, then the government would automatically assign the enterprises to investment banks in order to carry out trade sales to domestic and foreign investors. Note that even in the case of a trade sale, the workers in the enterprise would be entitled to a portion of the ownership on a discounted basis according to the privatization law. The combination of worker-management buyouts and trade sales could

¹³If the cutoff for "medium-sized" firms is put at 1,000 workers, this covers 2,200 of the 3,200 state industrial enterprises, and constitutes approximately 25 percent of the labor force in the state industrial sector. If the cutoff is instead put at 500 workers, that would include 1,400 enterprises with about 10 percent of the state industrial workforce.

result in the privatization of nearly all 2,200 state industrial enterprises with 1,000 employees or fewer in the coming year. (Remember that around 60,000 small shops have been privatized during the past year).

Triaging Large Enterprises

For large firms (defined here arbitrarily as firms with more than 1000 employees), the process of privatization will typically involve the distribution or sale of shares to several groups, including the workers and managers, financial institutions, households, and foreign investors. For each of the firms, it should be possible to sketch the basic method of share sales and distribution at the outset of the process. Most will follow a set course (with some shares to workers, banks, investment funds, and so on), while a small proportion of firms will be treated on an individualized basis from the beginning.

There are a few dozen very large, capital-intensive enterprises for which a foreign investor is clearly necessary to bring new technology, foreign management, and an infusion of capital to the firm. For these firms, it is extremely important to initiate the privatization process from the MOT, rather than to leave the negotiations to the enterprise itself. The Ministry should designate the list of firms for which it will negotiate with foreign partners.

The two car companies, FSO and FSM, are clear examples where future operations depend on attracting a leading foreign partner in

the near future. Investment banks will be necessary to help carry out the negotiations of such ventures. In the cases of sales to foreign partners, the government can retain, with little danger, a minority block of shares after the sale or merger with the foreign company, since the merger agreement will entail foreign management control. Eventually, this minority block of shares can be sold to the public. Workers will receive a concessional block of shares as well as defined by the privatization law.

There is another small group of firms that can be targetted from the outset for IPOs to domestic investors, in cases when it is particularly attractive to create a large population of small shareholders. The state-owned commercial banks would seem to be ideal candidates for IPOs, in view of the fact that commercial banks are prone to conflicts of interest (that is, various subtle and unsubtle forms of self-dealing) when their ownership is highly concentrated in particular hands.¹⁴ The lack of strong shareholder control over bank management that will result from the IPOs can be compensated by the regulatory oversight of the banks by the National Bank of Poland.

A third group of firms requiring special treatment from the outset are the firms that must clearly be closed down. One obvious group of firms that must be closed are firms that relied almost entirely on the Soviet market, which has now collapsed, and that

¹⁴The risk of self dealing is greatest when the commercial banks are owned by non-financial enterprises that use the bank as a source of loans. Note that it is generally prudent, indeed desirable, for banks to own portions of industrial firms, while it is generally undesirable for industrial firms to own banks.

will be unable to shift production to the domestic market or to the West.¹⁵ It makes little sense to expend the effort to privatize enterprises that are soon to be closed, especially since the privatization itself can create a new pressure group that will start fighting for subsidies or trade protection in order to keep the enterprises alive. This is certainly not to say -- as some do -- that privatization should only be for the firms in the "best" financial shape, or that firms should be financially "healthy" to merit privatization, but rather that the clear and persistent loss-makers on the verge of insolvency should be removed from the privatization process.

A procedure for mass privatization

For the hundreds of enterprises that are not targetted at the outset for sales to foreign investors, for IPOs, or for closure, there should be a process of mass privatization based largely on the distribution of shares to workers and financial intermediaries. A basic "cookie-cutter" approach, in which each of these hundreds of firms is treated in a similar way, is appropriate. While such a standardized approach might seem simplistic, it is the only realistic way to process a large number of firms, and even more importantly, to cut down on the amount of bargaining and rent-

¹⁵A taskforce of management advisors and investment bankers has been examining the prospects of around 40 firms hard hit by the collapse of the Soviet market. Their preliminary conclusions are that a large proportion of these firms will need to be closed down, since many have inadequate technologies in order to be able to retool and reorient to other markets.

seeking that will take place between the enterprises, the politicians, and the Ministry of Ownership Transformation.

The first step of mass privatization is to convert the enterprise into a joint-stock company under the company law. The registered capital of the enterprise can conveniently be based on the book valuation of the enterprise, rather than on a new, independent valuation. Initially, 100 percent of the shares of the company would be held by the Treasury. The first board of directors of the new company could be constituted within three months of incorporation. Under the law, this first board would be composed two-thirds by representatives of the government, and one third by representatives elected by the workers. Subsequent boards would be elected by the shareholders meeting.

The mass privatization should begin with the concessional distribution of shares to the workers and management in the enterprises. As noted earlier, the law envisions that up to 20 percent of the shares should go to the workers at "half price," but the lack of a clear "price" has so far meant that this provision has not been helpful in speeding privatization. For purposes of implementing the privatization law, it would be highly desirable simply to choose the book value of the enterprise shares as the basis for setting the concessional price of shares for the workers. The practical implication would be to avoid the need for an independent valuation or for an actual public sale of shares in order to determine the price for the sales to the workers.

The government should speed the distribution of shares to the

workers by enabling the enterprises to purchase the shares for the workers through an employee-stock-ownership plan. Most simply, the government could allow the firms to use some proportion of their accumulated profits since 1990 in order to purchase the workers' shares allowed by the privatization law. Such share purchases by the enterprises could be made tax deductible against the corporate income tax. Such share-purchase schemes for workers are currently blocked by various limits on compensation payments to workers that are part of the government's incomes policy for the state enterprises.

The next step could be a set-aside of up to 20 percent of the enterprise shares for the privatization of the pension fund program. Initially, this set-aside of shares would be allocated to several portfolios of shares, which would be managed by newly licensed pension fund managers. In the course of two or three years, these pension funds would be privatized by transferring workers from the state pension system to membership in one of the private funds.

The third step would be the set-aside of around 30 percent of the shares for inclusion in investment funds (the PMFs), as described earlier. The shares would be distributed to several portfolios, each of which would constitute a new, privately managed and privately owned investment fund. The investment funds would be constituted as share companies, whose shares would be distributed free of charge to the adult citizens of Poland. As discussed earlier, this will be an administratively complex task so that the

actual design of the task should be as simple as possible. Rather than allowing individuals to choose their investment trusts, they could simply be assigned to one of the trusts on a random basis. Also, rather than allowing the investment trusts to bid for their initial portfolio of shares, the investment trusts should simply receive an allocation of shares.

The fourth step of the distribution of shares would be to give shares to the state banks that are in the process of privatization. Each of the banks could receive a small proportion of shares (say up to 5 percent) of several large enterprises. The state banks would initially receive the shares as a trustee for the Treasury, rather than owner, and the shares would actually be transferred to the banks only upon privatization. As with the mutual funds, the banks would have a strict ceiling in the proportion of an enterprise's shares that it could hold, say below 10 percent. As part of the bank rehabilitation project now underway with the IMF and the World Bank, special efforts would be undertaken to help prepare the banks to manage the new portfolio of industrial shares.

If this process of mass privatization were carried out as recommended, the Treasury would distribute around 75 percent of the shares of the enterprises (workers and managers, 20 percent; pension funds, 20 percent; investment funds, 30 percent; banks, 5 percent). The remaining 25 percent would remain initially with the government. These shares could be sold in due course to foreign investors (perhaps as a block of shares, in order to grant management control), or to the public through public offerings.

There would be no urgency in the final disposal of these shares, however, since the bulk of the privatization process would already have been accomplished.

One way to limit the overly mechanistic aspects of this program, without slowing the privatization process, would be to set in place additional mechanisms for considering alternative privatization proposals brought from outside investors (and from the enterprises themselves) during the course of the year in which the mass privatization is carried out. For example, if an enterprise receives a foreign bid during this period, the MOT should have a clear procedure for appointing a trustee to consider the adequacy of the bid, and perhaps to solicit competitive bids.

The free distribution scheme should not stand in the way of more "normal" methods of privatization when potential buyers have identified themselves. The mass privatization scheme is merely to be used because the vast majority of firms will not receive adequate bids in the next few months.

Some measures to accompany rapid privatization

There are several tasks that should be carried out in concert with the privatization process in order to allow a proper functioning of the capital markets.

First, and most important, is the design and implementation of clear bankruptcy procedures for state-owned companies. There is no clear legal mechanism for closing state-owned firms at this moment. The result is a massive bleeding of state assets that is out of

control, and will be very expensive for the Treasury, and will lead to a significant misallocation of capital resources.

Loss-making firms with no prospects of recovery are currently able to continue to operate with impunity by running down bank balances and liquidating assets. Several firms in the Soviet-trade sector have been found recently to be living off of such asset liquidations, without any realistic prospects for generating future cash flows from production. Workers and managers in these enterprises realize that they are in an endgame: since the enterprise is likely to fail in any event, their best strategy is to "milk" the enterprise for all they can get in the short term. Wage demands are strong in such enterprises despite the weak financial condition of the firm, since workers know that even with wage restraint the enterprise is likely to fail.

The problem is that neither the government nor the creditors of a loss-making enterprise (mainly the state banks) have clear legal procedures for forcing a suspension of operations of the enterprise and liquidating or reorganizing the firm. The government should create an administrative procedure whereby the creditor banks are able to intervene to protect their claims on the enterprises before the enterprise assets are dissipated. For such a procedure to operate, there must be a clear mechanism by which the creditors benefit from the enterprise liquidation -- either by receiving the cash generated by the sale of enterprise assets, or by taking over the equity of a financially restructured firm. Such mechanisms (akin to Chapters 7 and 11 respectively of the U.S.

Bankruptcy Code) do not now operate.

Because of the large number of firms that must be liquidated, and the absence of an experienced court system to manage the process, there is the need for expedited administrative procedures. Creditors should have the authority to force firms into the hands of a government-appointed administrator, who will have the responsibility to liquidate the firm, perhaps operating in conjunction with the MOT, the courts, and with outside advisors.

A second clear task is to help prepare the new privatized enterprises to function according to company law. The government has an initial responsibility to identify and train capable members of the supervisory boards of newly privatized enterprises. While this process is underway, it has gone too slowly in at least one regard: there has been little attempt to recruit Polish-emigre businessmen to serve as board members. The government should undertake an organized effort -- with the help of international executive search firms --to identify and recruit thousands of potential new board members.

Another aspect of helping firms to operate as private companies is to encourage the use of international management expertise. In some important enterprises, it is necessary to identify an entire new management team. Often such a management team can best be recruited internationally. The need for new management is especially pressing in some of the large and socially sensitive sectors such as coal and steel, where there will have to be significant cutbacks of employment. Poland would do well to

emulate the example of British Steel, which brought in an internationally renowned foreign manager, Ian MacGregor, to oversee the process of retrenchment and technological upgrading.

One idea that has been discussed in Poland is to establish a "Prime Minister's Fund" to channel international financial assistance to individual enterprises in order to cover the costs of foreign and domestic management consultants. For political and economic reasons, the Fund would aim to be available to every industrial firm that is interested in bringing in outside assistance for restructuring. The Fund would cover a proportion, say two-thirds, of the costs of the management experts, while the enterprise would cover one-third of the costs.

A third area of urgently needed development is in the legal administration of privatization. Basic concepts of property management, such as the use of bond covenants to protect creditors, or the designation of senior and junior creditors, are virtually unutilized, and are often unknown, in Poland. Basic instruments of privatization, such as the "liquidation" procedures (which constitute a leveraged buyout by workers and managers), have not been properly scrutinized. Nor does the law provide for standards of care for managers or boards of directors of state-owned enterprises in considering bids for mergers or sellouts to foreign investors.

A fourth area of needed attention is in the design of compensation schemes for state enterprises and newly privatized enterprises. To this point, there has been little use of

incentive-based compensation packages, such as stock options for managers, employee-share ownership schemes for workers, and profit-sharing for both managers and workers. It is very pressing to consider the design of such schemes, since they interact closely with the privatization process itself. Should enterprise managers receive stock options in state-owned joint-stock companies? Should tax laws encourage the use of employee share ownership schemes, as they do in the U.K. and the U.S. Would these arrangements introduced before privatization have detrimental effects on the privatization process itself? Such questions have barely been addressed to this point.

V. The Role of the International Financial Institutions

The international institutions have a crucial role to play in the privatization process. To carry out this role, it is essential that they first recognize the importance of speed. Otherwise, the the World Bank and other institutions might inadvertently slow the process of privatization by fostering the illusion of government-led restructuring of the industrial sector as the "prelude" to privatization.

The task of mass privatization will require large-scale administrative support, much of it employing international expertise, and a flexible expenditure of funds to recruit that expertise. Most international support for privatization -- whether from the World Bank, the EBRD, the Know-How Fund, etc. -- comes with so many strings attached that it is hard to employ flexibly.

Special efforts should be made to increase the operational flexibility of donated funds.

It is useful to reiterate the tasks that require urgent support. In each case the international institutions can provide vital financial support for the task:

- legal assistance on the design of privatization procedures, including the design of worker-management buyouts, auctioning procedures, appointments of trustees in cases of foreign bids, preparation of contracts for financial intermediaries, including pension funds and mutual funds

- financial assistance in the design of the privatization of the pension system (which is, as yet, not worked out in detail)

- recruitment of investment trust management groups and pension fund management groups

- identification and training of supervisory board members, especially with the support of international executive search firms

- identification and training of management teams for selected state industrial enterprises that are in the process of privatization

- management assistance for state commercial banks in the process of privatization, including training to hold and manage industrial equities

- funding to recruit international investment banking groups to carry out trade sales and IPOs for the enterprises that will not participate in the mass privatization process

With an ambitious timetable and careful coordination among the Polish Ministry of Ownership Transformation, the World Bank, and the EBRD, it should be possible to set up the teams to carry out these tasks, and thereby to put the privatization program on a rapid and irreversible course. But the opportunity to do so may last only for a few months. After that, the encroaching political

realities could well slow the process dangerously.

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